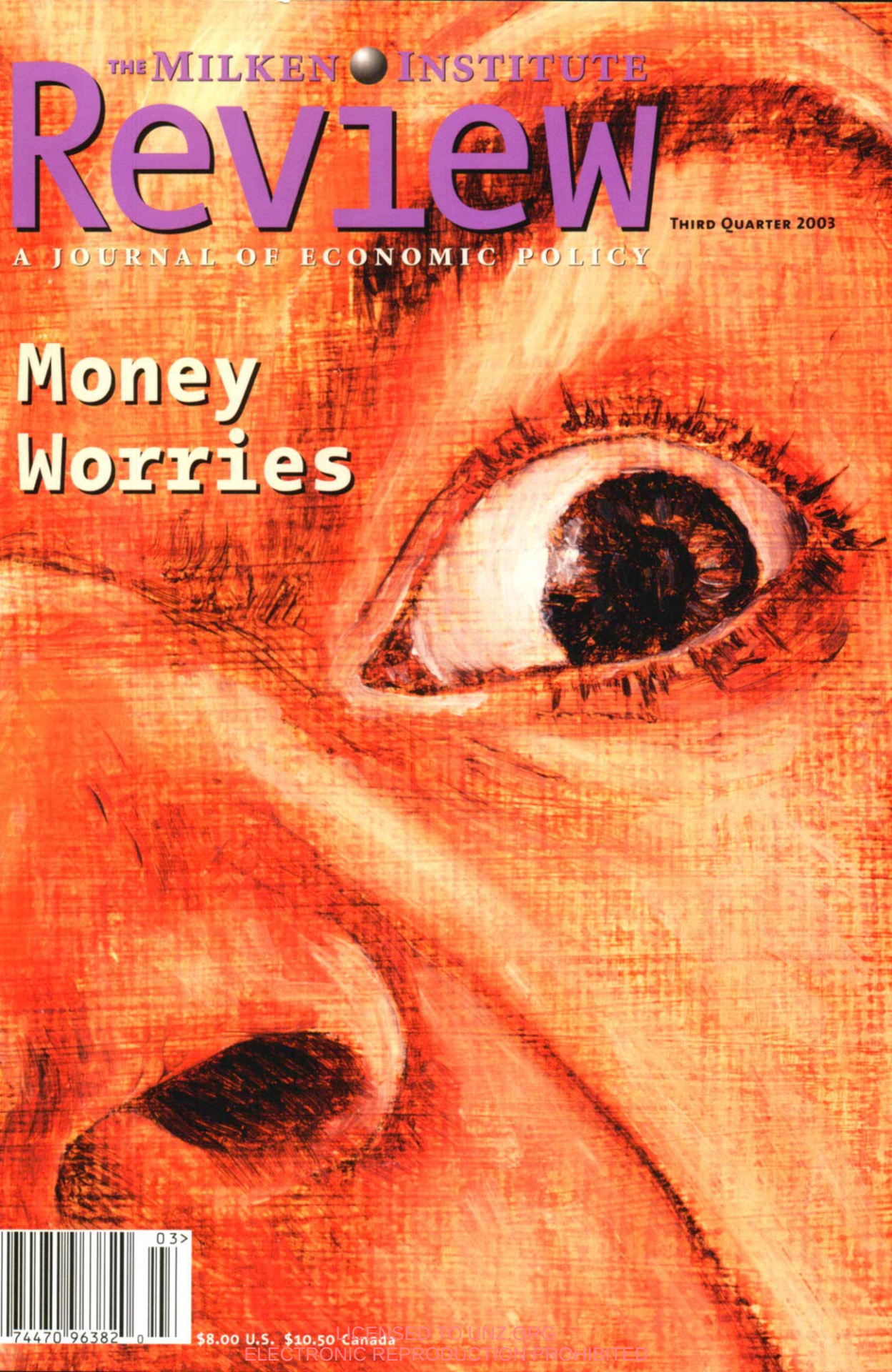
THE MILKEN INSTITUTE

Review

THIRD QUARTER 2003

A JOURNAL OF ECONOMIC POLICY

Money Worries



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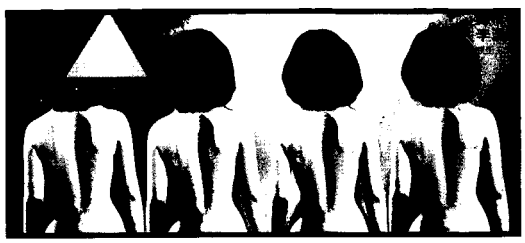

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FROM THE PRESIDENT

People who know the Milken Institute is small compared to most think tanks are often amazed by how much we accomplish. While some of our work is public – from the publication of this magazine to our annual Global Conference – a great deal of what we do goes on without fanfare.

Since the mission of the Institute is "to improve the lives and economic conditions of diverse populations in the U.S. and around the world," our behind-the-scenes efforts focus on economic development. To this end, we partner with a variety of organizations with complementary goals, from corporations trying to be good public citizens to nonprofits with explicit missions ranging from regulatory reform to the securitization of small business loans.

Here is a sampling:

- We're working with the Ford Foundation to increase the flow of capital to overlooked and underappreciated parts of the U.S. economy – from minority- and women-owned businesses to rural communities.
- We have teamed with the California Trade & Commerce Agency and local nonprofits to research ways to reduce the Central Valley's dependence on agriculture and to attract industry to the region.
- We are part of a team providing advice to China's government on regulatory reform for the financial system.
- We're advising the New England Healthcare Institute on trends in health care, with the goal of making the region more attractive to providers. [See Ross DeVol's Institute View on page 91 of this issue.]
- In partnership with the nonprofit Nehemiah Corporation, we are studying ways to make home mortgages more affordable for low- and middle-income families.
- We're assisting the State of Nebraska with its initiative to attract technology-based industry and a highly skilled workforce.
- We've partnered with municipalities and nonprofits in Israel, including the Jerusalem Center for Public Affairs, helping to reform markets strangled by regulation.
- We have worked with a number of state pension funds to identify emerging domestic-market investment targets and to develop methods for financing their growth.

We've also begun a major effort in health care. The Center for Accelerating Medical Solutions will examine the medical research process with a goal of changing institutions that slow progress in reducing the toll from diseases. The Center is now establishing operations in the Washington, DC area.

We are excited about these projects, and are proud to have these organizations and entities as our partners. If there are projects you would like to pursue with the Milken Institute, please let us know.

Michael L. Klowden
President and CEO

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Is the cover of this issue a knockout, or what? For that matter, isn't the whole issue a treat to the eyes? Credit **Joannah Ralston** of Insight Design in Vermont, who has done it all since the start – she even found the campy movie posters that illustrate our latest book excerpt.

And this time around, we've got copy that lives up to the visuals.

Start with **George Feiger's** insights on the unintended consequences of the Fed's efforts to bring the economy out of recession. Feiger, a senior adviser to the Monitor Group consulting firm, points out that cutting interest rates redistributes income, even as it lowers the cost of business investment. And the folks – mostly retirees – at the short end aren't about to accept their lot with stoicism.

"Retirees living on their investments have experienced devastating reductions in consumable income – down to $10,000 to $30,000 per year per million dollars of financial assets," he notes. "Predictably, many of these investors have been aggressively, even desperately, scrambling for higher yields. Wall Street is responding in a way that starkly reveals the risks individual savers run in dealing with a commission-driven retail savings industry."

Rudy Penner, a senior fellow at the Urban Institute and a former director of the Congressional Budget Office, examines the controversy over estimates of the cost of federal tax and spending initiatives. In particular, he analyzes the debate over "dynamic scoring" – the practice, dear to the hearts of supply-siders, of factoring in the potential tax gains from accelerated economic growth.

"Although the contretemps over dynamic scoring has been educational," he writes, "it has diverted attention from much more serious problems with the current scoring process. For example, important distortions result from using a 10-year time horizon that scores the impact for the 11th year as zilch. These distortions are particularly serious when considering changes in the taxation of capital income."

Peter Orszag, a senior fellow at the Brookings Institution, examines the states' collective $80 billion budget deficit and is more than a little disturbed by what he finds. "After two years of budget trims, states have largely run out of easy options. They are now cutting

TOM NICK COCOTOS

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health care for the poor, slashing higher education spending, releasing prisoners early, and even unscrewing light bulbs to save on utility bills," he writes.

"These actions are harmful not only from a social perspective, but also from a macroeconomic one," he adds. "They are a sort of 'anti-stimulus,' reducing demand ... just when the economy has capacity to burn."

Len Burman of the Urban Institute and **Joel Slemrod** of the University of Michigan Business School make serious fun of economists' inability to find common ground on tax policy. "In large part," they explain, "the tax debate is not about who should pay or about how to kick-start the economy, but rather about the size and scope of government. No economist believes that running large and growing deficits is sustainable policy. But conservatives are willing to run deficits for a while if doing so will starve the metaphoric beast. Liberals say that starvation doesn't work, but they fear that it will."

Marsha Vande Berg, the publisher of *The World Report*, a San Francisco-based newsletter, investigates China's latest efforts to modernize its state-owned banking system.

"Some argue that the situation is not as grave a threat as it first appears because the Chinese government guarantees most of the bank debt and has considerable assets to make good on bank liabilities," she writes. "However, failure to clean up the banks' balance sheets could undermine the confidence of foreign investors who poured $52 billion (along with vital industrial technology) into the Chinese economy last year in the form of direct investment."

Richard McKenzie of the UC (Irvine) Graduate School of Management and **Tibor Machan** of the Argyros School of Business and Economics in California take on pundits and educators who claim that the best way to make business leaders behave ethically is to teach ethics in school. "Their logic is straightforward," say McKenzie and Machan, "though hardly psychologically sophisticated: If executives have had ethical lapses (which few dispute), then teach budding executives the difference between right and wrong. We believe that such MBA-level instruction would surely do little harm. However, there are good reasons for believing it wouldn't do much good either."

As usual, we offer the unusual insights of Nobel Prize-winning economists from the Milken Institute's annual Global Conference, led in a roundtable discussion by **Michael Milken**. This year, **Ken Arrow** (Stanford), **Gary Becker** (Chicago) and **Myron Scholes** (Oak Hill Platinum Partners) diagnose the ills of the Japanese and German economies, ponder the problems of unifying the two Koreas, give a thumbs-down to Europe's experiment with a common currency and forecast the growth of the Chinese economy. Then, they really get down to work...

And there's lots more. **Ross DeVol** describes the Institute's new work on regional health-care clusters. **Bill Frey** weighs in with a Charticle on multi-race marriages. And don't forget the aforementioned book excerpt: **Tyler Cowen** of George Mason University explains why, thanks to the economics of globalism, James Cameron really is the king of the world.

— Peter Passell

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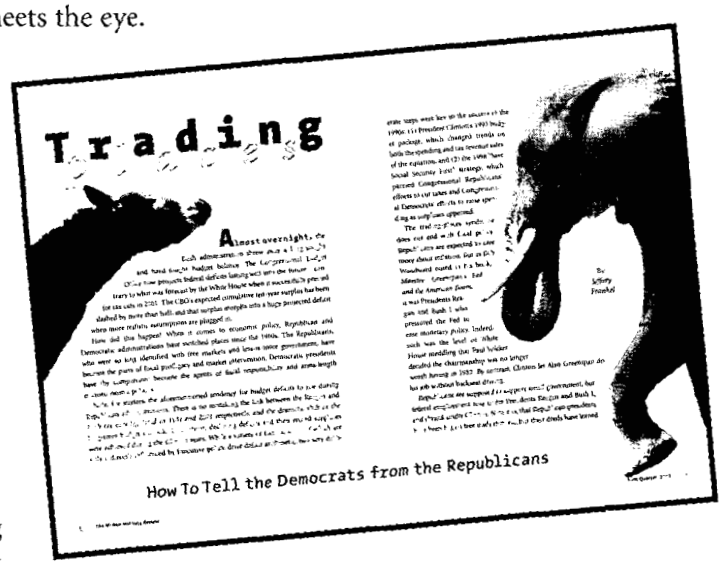
BY ROBERT B. EKELUND, JR. AND MARK THORNTON

We certainly agree with Jeff Frankel (*Milken Institute Review*, 1st Quarter 2003) that the "Republicans have become the party of fiscal irresponsibility, trade restriction, big government and failing-grade microeconomics." However, we would argue that there is less mystery to this exchange of economic platforms with the Democrats than meets the eye.



The Republican Party was established in the 19th century as a party of big government and economic intervention. Its reputation as a party of limited government is of more recent vintage. And the retirements of Phil Gramm from the Senate and Dick Armey from the House – both conservative economists – mark the continuing regression toward its roots.

The Republican Party that emerged in the 1850s was a hybrid with many parents. One founding group came from the Free Soil Party, which advocated free land and other subsidies for farmers. In contrast, Democrats of the era wanted to sell off the vast public lands of the Midwest and Great Plains in order finance government without high tariffs or deficit spending.

Supporters of the Know Nothing Party also joined the nascent Republican Party. They were motivated by resentment of immigrants – and, more specifically, resentment of the competitive pressure the new arrivals put on wages. Not surprisingly, the Know Nothings favored immigration restrictions, along with protective tariffs to bolster returns to unskilled labor. So here, too, the contrast with the position of the Democratic Party of the time, which supported both immigration and free trade, was stark.

Also joining the Republican ranks were Prohibitionists (who wished to bar slavery in the West) and Abolitionists. Members of the Republican Party generally shared an opposi-

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tion to slavery, advocating policies of containment, emigration or emancipation. The Democrats, for their part, generally supported states' rights, limited federal government and economic prudence. They typically backed slavery in the South and legal segregation in the North.

Protectionism was Job One for the early Republicans.

The ambitious economic agenda of the young Republican Party had ideological roots in the ideas of Federalist icon Alexander Hamilton and Whig leader Henry Clay. They favored protective tariffs for manufacturers, a national bank, and plenty of public works and patronage. The flurry of laws, regulations and bureaucracies created by Abraham Lincoln and the Republican Party during the early 1860s is similar to that of Franklin D. Roosevelt's "New Deal" for their volume, scope and questionable constitutionality. In fact, the term "New Deal" was coined in 1865 by Daniel Elazar, a newspaper editor in Raleigh, North Carolina, with the objective of putting Lincoln and the Republican Party platform in a favorable light and persuading North Carolinians to rejoin the Union.

Protectionism was Job One for the early Republicans. They passed the Morrill Tariff, which raised levies on manufactured imports to extremely high levels. The policies of the early Republicans, like those of their present-day counterparts, yielded large budget deficits. Pre-Civil War Democrats, by contrast, worked effectively to eliminate the national debt.

Favoritism for big business has always been a hallmark of the Republican Party. Then and now, they tend to support subsidies, public works projects and regulations that are in the interest of incumbent businesses. Indeed, the biggest public works project in the nation's history was building the intercontinental railroads, an initiative that truly galvanized the membership of the Republican Party. Republicans also created the Interstate Commerce Commission, with the nominal task of regulating rail monopolies. In fact, the ICC pre-empted far more ambitious pro-farmer efforts by the states to regulate rail tariffs.

The Republicans started out as a party with a mercantilist agenda – what today would be called "rent-seeking" – inviting interest groups to lobby government for special privileges ranging from monopolies to trade protection to government pork barrel contracts. It is no coincidence that the party's ascendance triggered a plague of government corruption.

How, then, did the Republican Party gain the reputation as a free-market, limited-government party? In part, because Democrats upped the ante with the anti-market policies of Roosevelt's New Deal. Another reason is that historians confused Republican support for the cowboy capitalism of the 19th-century robber barons with pro-market policies. But allowing a free market in government favors is hardly the sort of laissez-faire policies favored by free-market economists or libertarians.

In fact, all of the modern policy issues discussed by Jeff Frankel were very much in play during the early days of the Republican Party. The Republicans have not mysteriously switched positions with Democrats, but have simply switched back to the policies that built the party in the first place.

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BY WILLIAM H. FREY

Fresh census numbers on mixed-race marriages give new life to the hoary idea that opposites attract. Although we are far from the goal of a color-blind society, biracial unions did increase 65 percent between 1990 and 2000, according to my analysis of newly released data. Interracial couples now comprise one in 15 marriages in the U.S. – up from one in 23 in 1990.

COLOR LINE MELTDOWN

The rise in mixed-race marriages coincides with exploding immigrant populations of Latinos and Asians – note that we treat Latino as a racial category. Nearly three out of 10 marriages involving Latinos or Asians is a mixed-race marriage. Indeed, nearly half (1.8 million) of the 3.7 million interracial marriages in the country include a Latino.

Interracial marriages involving African-Americans are much rarer, despite the fact that blacks comprise a similar share of the U.S. population as Latinos, and are about three times more numerous than Asians. Only about one in eight marriages involving African-Americans are of mixed-race. At the other end of the spectrum, nearly three of four marriages involving Native Americans, Eskimos and Alutes are interracial.

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BILL FREY is a senior fellow in demography at the Milken Institute and a visiting fellow at the Brookings Institution in Washington DC.

MIX AND MATCH STATES

Not surprisingly, the "melting pot" states tend to have the highest prevalence of mixed-race marriages.

Almost one-third of marriages in Hawaii are so classed. In eight other states – Alaska, New Mexico, Oklahoma, Nevada, California, Arizona, Colorado and Washington – at least one out of 10 fit the billing.

The large Eskimo and Aleut populations in Alaska, as well as the Native American populations in Oklahoma, account for the high proclivity of mixed-race marriages in these

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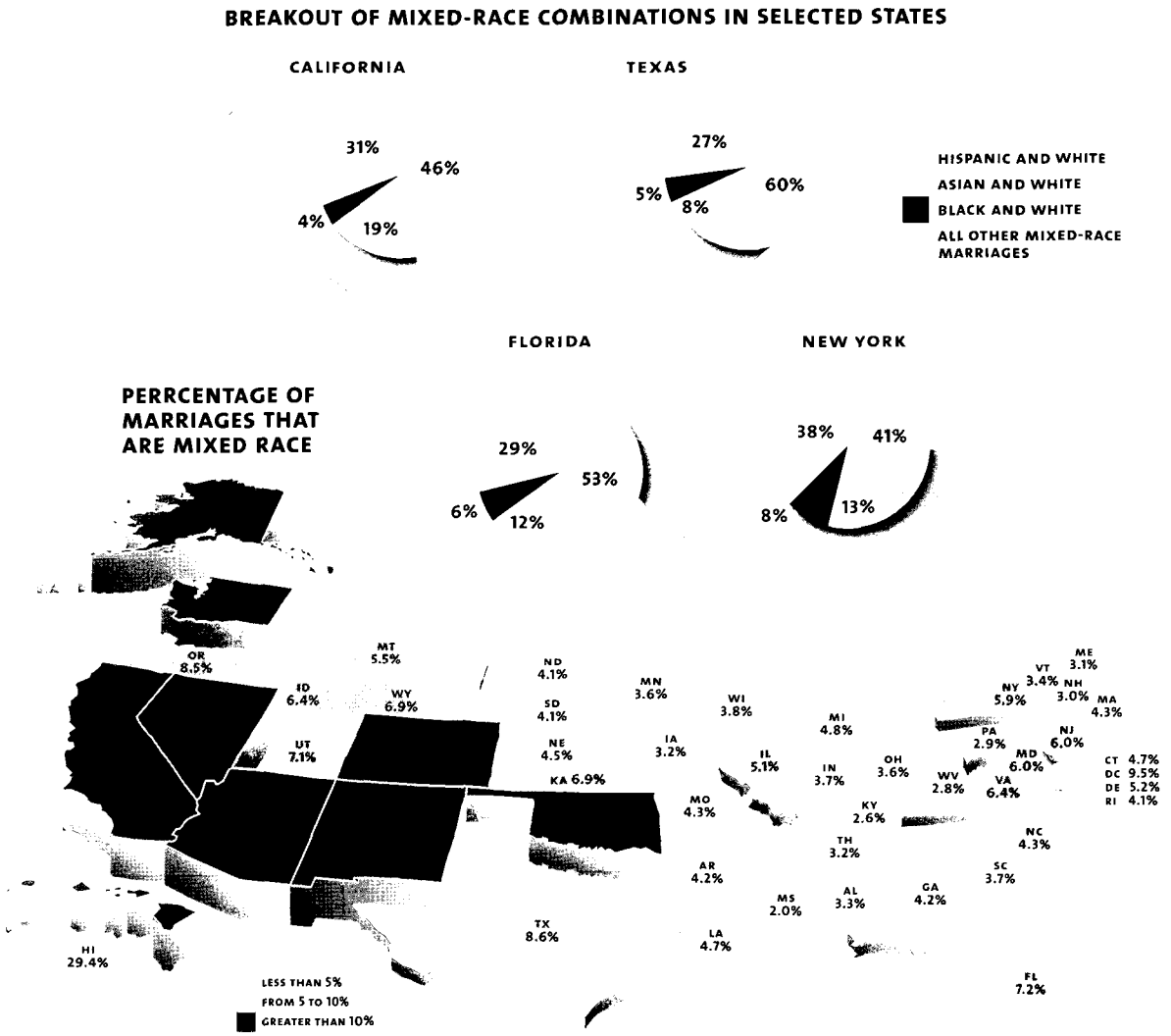

two states. Hispanic and Asian populations tend to dominate in the remaining mixed-race marriage havens.

In 27 states, including much of New England, the Midwest and the Great Plains, less than 5 percent of all marriages are interracial. This is also the case in much of the South, where African-Americans comprise a significant share of the non-white population.

But race barriers are becoming more porous almost everywhere: Interracial marriage increased in Tennessee by 133 percent in the 1990s, with Nevada a close second at 120 percent. Even largely white states like West Virginia and Vermont showed a doubling in mixed-race marriages.

CHARTS: BRUCE SANDERS AND MAX HARLESS

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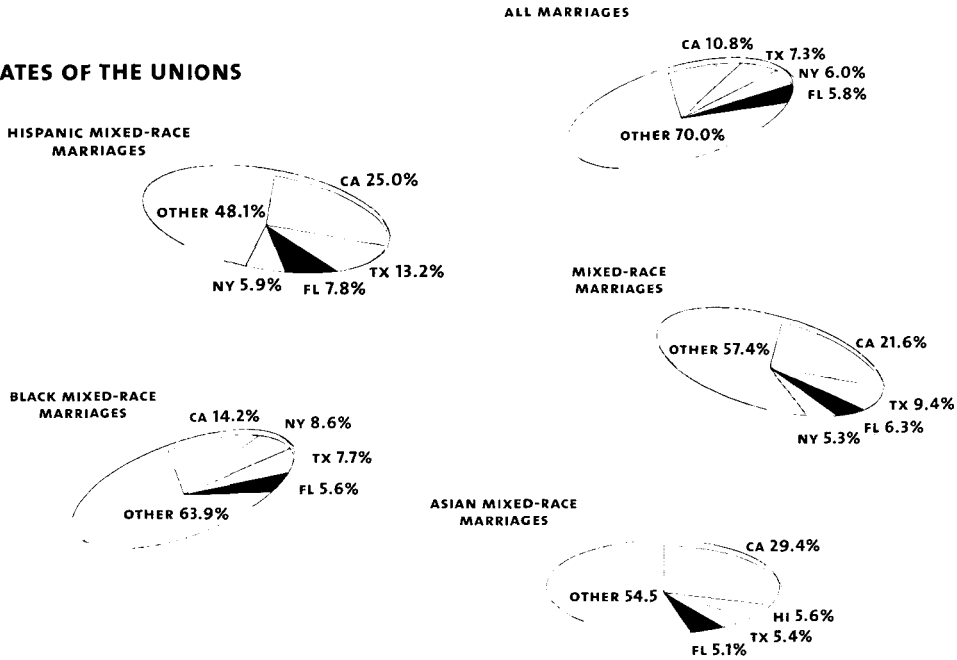
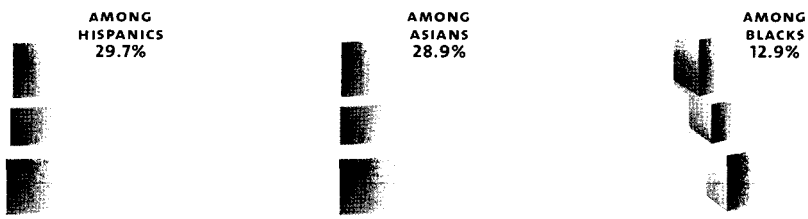
CHARTICLE

STATES OF THE UNIONS



PREVALENCE OF MIXED-RACE MARRIAGES



MIXED-RACE MARKET SHARE

Most mixed-race couples reside in California, Texas, Florida and New York. The Golden State is home to only about one in 10 married couples, but more than one in five interracial couples – which reflects the melting pot tendencies of regions with large Latino and Asian populations. Indeed, California is home to one in four of all mixed-race marriages involving Latinos, and nearly one in three involving Asians.

LOCAL ATTRACTIONS

Nationally, more than 1.5 million of America's mixed-race marriages are Latino-white. And in heavily Latino states such as California, Texas and Florida, Latino-white marriages account for well over half of all mixed-race marriages.

Nearly one-half of Oklahoma's mixed-race marriages is an American Indian-white combination, while in Hawaii Asian-white combinations far outdistance others.

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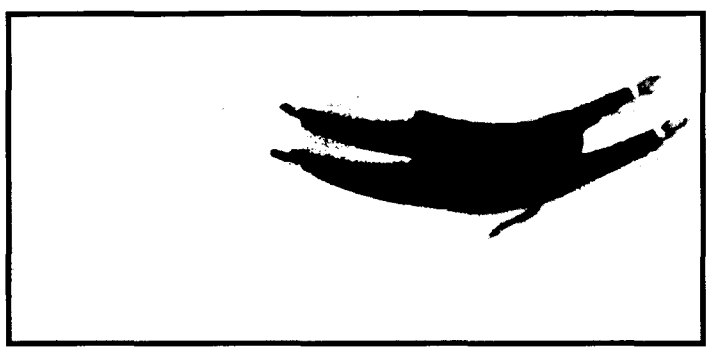
BY GEORGE FEIGER

The current economic cycle, from Internet boom through Enron bust, has been unusually extreme. The Federal Reserve has responded as expected, lowering interest rates time and again, in an effort to stimulate demand.



These low rates have yet to generate much business investment. But they have made it possible for fiscally challenged corporations and municipalities to issue higher-yielding – and riskier – debt, as Treasury and CD yields have fallen to historic lows. And they have permitted an unprecedented flood of mortgage turnovers by homeowners, who have borrowed hundreds of billions more against their bloated equity to sustain personal consumption.

From the perspective of *demand management*, the overriding priority of the Fed – easy credit – is just what the doctor ordered for recessions. However, returns on bonds, bank CDs and other securities are also a source of income for investors. Indeed, for a minority of relatively affluent retirees, investment returns are the primary source of retirement income. And for them, the last three years have been an unmitigated disaster. A blind scramble for yield by many of them holds the promise of magnifying this disaster still further.

More ominous, the fate of this small group threatens to become the fate of much larger numbers of retirees in the next few decades, many of whom are far from affluent. With fewer companies providing pensions of any sort, a far greater proportion of retirees will come to rely on investment returns for their bread and butter. Accordingly, the policy of driving down interest rates to rid the economy of recession could easily come to mean extended periods of financial distress for millions. This threat will, in all likelihood, constrain makers of monetary policy. It could also lead to much greater regulation of private savings behavior, and limit the role that today's brokerage-oriented savings industry can play in the retail marketplace.

GEORGE FEIGER, of Wellesley, Mass., is a senior adviser at Monitor Group, a financial services and consulting firm. He was global head of onshore private banking for UBS and was SBC Warburg's global head of investment banking.

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LEAN TIMES FOR THE NEARLY RICH

A former business colleague who lives on his savings asked what he should invest in that would yield enough to maintain his standard of living. On reflection, all I could suggest was to buy a laundromat or two, or a do-it-yourself car wash. After three years of Fed rate cuts, such investments (of which there are not nearly enough to go around) are about all that are left that generate attractive, reasonably reliable yields.

About half the households in the United States with financial assets exceeding $1 million (exclusive of primary residence) are supported by retirees. Lower the bar to $500,000 and the proportion hardly changes. A significant number of these retiree households (precise estimates do not exist) depend in large part on their financial assets for income. And with the exception of those retirees who are truly rich, their economic prospects have come under considerable threat. Most retirees' net worth has fallen significantly along with the stock market. But their income has fallen more.

CDs and other short- and medium-term conventional fixed-income investments, now yield just 1 to 2 percent. True, this is the same range as the dividend yield on equities when people were buying stocks by the cartload in the 1990s. But in the market's golden days, investors could always supplement dividend income by realizing capital gains. No longer.

These largely upper-middle-class investors typically owned some bonds, too, which made remarkable gains as interest rates fell. However, many owners of fixed-income securities did not reap the full benefit; holders of mortgage-backed paper – Fannie Mae pass-through securities and the like – have faced the most dramatic prepayment rates we have ever seen. They must now reinvest this capital at derisory rates.

On reflection, all I could suggest was to buy a laundromat or two, or a do-it-yourself car wash.

At the same time, holders of corporate paper have seen much of it downgraded – often to junk status and sometimes into bankruptcy. This same recession has created the greatest crisis in state and municipal finances in a generation, and this has been reflected in the rating of municipal bonds. So investors have been taking capital losses even in the fixed-income asset class.

Overall, then, retirees living on investments have experienced devastating reductions in income – down to just $10,000 to $30,000 per year per million dollars of financial assets. Predictably, many of these investors have been aggressively, even desperately, scrambling for higher yields. Wall Street is responding in a way that starkly reveals the risks individuals run in dealing with a commission-driven retail savings industry.

Some of today's hottest investment products are closed-end mutual funds and hedge funds whose strategies are based on asset/liability mismatches. Buy a portfolio of 5- to 10-year municipal bonds, leverage it two or three times with borrowed one-week money, and you can produce a 6 to 7 percent tax-free return. Do the same with taxable interest-bearing securities, and you can produce more than 8 percent – a seductive lure for holders

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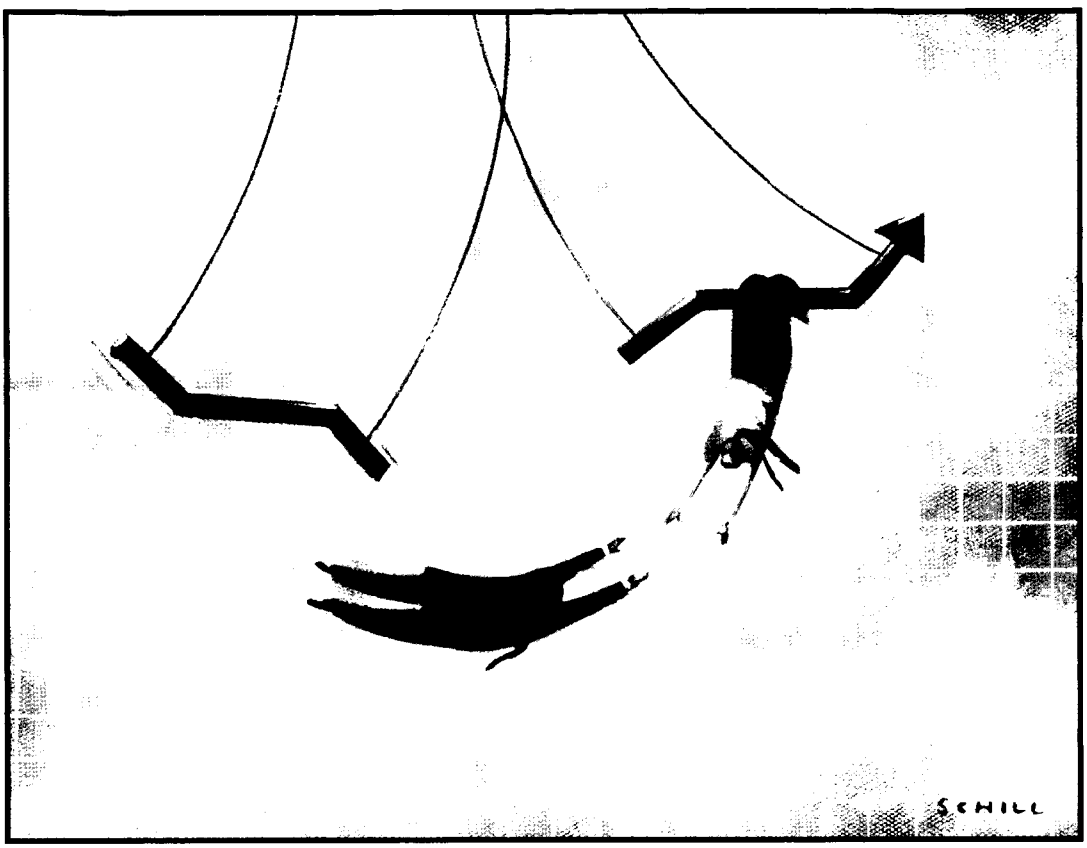

of IRAs and other tax-deferred accounts.

These products generate very high commissions for brokers, who have been eloquent in explaining the benefits. However, they plainly have not been as eloquent in explaining the extra risk. If the yield curve rises and longer term interest rates sink below short-term rates, investors in the mismatch funds will lose all of their income and much of their capital. Thus, over what is likely to be a six- or seven-year period, they will have taken a double blow – first in equities, then in fixed-income assets.

Prudent financial planners – those who are not recommending leveraged closed-end funds – are already telling middle-income retirees to consume less and to sell their houses. Or even to go back to work.

This is not advice easily given, or followed. Jobs are hard to find these days, especially for people over 60. Moreover, the hot market for housing is showing signs of cooling off. In the affluent suburbs of Boston, for example, there is more real estate on the market now than at any time in recent years.

Sadly, many retirees accustomed to the good life are consuming capital faster than is viable. Even sadder, they will soon have a lot of company in their misery.

A DIFFERENT KIND OF TRICKLE-DOWN ECONOMICS

When free-market economies are working right, what is good for the affluent is also good for the majority. However true that may be, the converse statement – what harms the

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more affluent will end up harming the majority – is almost certainly true in the case of retirement income.

The travails of today's upper-middle-class retirees will, without doubt, be visited in magnified form on the baby boomers. This follows from the fundamental change in how retirement is funded. Since World War II, most retired Americans have depended on a mix of employer-funded pensions and Social Security. Employer pensions, and associated benefits like health insurance, were typically adjusted for inflation.

But these once-commonplace perks are becoming harder and harder to find. Employers are actively capping defined-benefit pension plans and ending post-retirement upgrades of benefits. Yet, in spite of this shift in risk from employer to employee, corporate pension plans on average are seriously underfunded and may be unable to deliver the benefits they (still) promise. Moreover, the magnitude of the funding shortfall vastly exceeds the assets of the government's Pension Benefit Guaranty Corporation.

From time to time, Republicans have floated the idea of moving at least a portion of Social Security contributions to self-directed investment accounts. This mirrors the private sector's desire to push current employees into self-directed retirement plans like IRAs and 401(k)s, with limited employer contributions. While the details of how we will get from here to there are far from clear, it is very likely that within a decade or so the majority of retirees will be literally living on yields – or eating into principal.

The irony here should not be lost. The problem that corporate pension plans cannot solve – finding sufficient yields – is trickling down to the retirees themselves. As we have seen, the current crop of more-affluent retirees has not been able to solve this one either.

The Era of Collective Good Feeling in retirement is on the verge of giving way to the Era of "Where's mine?"

Worse still, the great majority of retirees dependent on private investment returns will have more-limited resources than the more affluent retirees of today. When interest rates are seen from the Fed's demand-management perspective as a cost of borrowing, it is not unreasonable to defer trading in the car or accelerating the purchase of a home as interest rates change. However, for those who rely on investment yields for basic needs, deferral of purchases is simply not possible. You can't skip lunch for 18 months until bank CDs start paying decent returns.

These IRA and 401(k) retirees will not be in a position to buy a car wash to escape from low CD yields. Nor will they be able to sell second homes or to trade down from suburban McMansions to two-bedroom apartments. And when millions of retirees apply for part-time jobs as grocery checkers to make ends meet, supermarkets may or may not wish to hire them.

Put another way, the Era of Collective Good Feeling in retirement is on the verge of giving way to the Era of "Where's mine?"

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These concerns will sooner or later make their way to Congress and the White House – not least because the elderly vote more frequently and reliably than the young. And the way politicians cope is likely to have profound implications for both macroeconomic stabilization policy and for regulation of the securities/saving industry.

GREENSPAN (AND THE BROKERS) IN HANDCUFFS

If one American in five lived on interest income, it would take a brave policymaker to drive short-term rates down to current anemic levels. If investment assets were all that sustained these Americans, New York State Attorney General Eliot Spitzer would not have stopped where he did in his recent pursuit of alleged perpetrators in the securities business. And the class-action lawyers would be trying to build a case against the brokerage industry that would make asbestos claims seem paltry.

We have no reliable techniques for ending business downturns or for preventing bubbles in the markets for liquid assets. Recent research into so-called behavioral economics has affirmed that market movements are less inspired by the rationality so beloved by free-market cheerleaders and more by short-term enthusiasm and herd instincts. This makes significant market volatility likely for the indefinite future. That, in turn, means that the conflict between demand management and income management will not go away. In fact, it is likely to compete for the top spot on the economic-policy agenda in coming years. I expect that policy will be pushed in a variety of directions (see box).

It's not clear whether a slower Fed response to economic downturns will make the business cycle more or less volatile. However, there is little question that the other policy

Responding to the yield curve

1. Fed actions will be more tempered. With yield movements driving retiree income, the Fed will have to think twice before changing course. Put bluntly, the baby boom retirees won't take anemic returns lying down.

2. Families will be forced to save. In the end, the best way to ride out volatility is to have a bigger cushion to ride on. Americans are not savers – which is one reason why they succumb so readily to the brokers' siren song of investments that can only go up. The Republican side of the aisle, ever hopeful that people will act in their own interest without a shove from Uncle Sam, won't like the implications. But a likely consequence of dumping the risks of retirement on retirees is a policy, similar to ones already in place in Australia and Singapore, of forcing folks to save a portion of their paychecks, rather than merely encouraging savings with tax breaks.

3. Savings assets will be firmly nudged into less-volatile structures. One way or another, Americans will be encouraged to diversify stock holdings and to "ladder" fixed-income asset maturities to reduce income volatility. Indeed, if Washington forces earners to save, it will probably also force them to invest conservatively.

4. Financial innovators will focus on ways to convert illiquid assets to cash. Now-exotic vehicles for consuming equity – everything from reverse mortgages to shared-appreciation mortgages to viatical life insurance transfers – will become commonplace.

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responses would transform the savings industry. Truly active investing may well become the province of qualified investors with high net worth, just as hedge fund investing is today. Everyone else will be steered toward passively managed, diversified investments like index funds, where transaction costs are very low. It follows that there will be little need for a large securities intermediation industry to deliver the goods.

Truly active investing may well become the province of qualified investors with high net worth. Everyone else will be steered toward passively managed, diversified investments where transaction costs are very low.

Forced savings will have an even more substantial impact on the wealth-management industry. Total personal savings will presumably rise, but little of this money is likely to find its way into the sort of savings vehicles that generate hefty sales commissions. Rather, as with 401(k) plans today, savings-sales staffs will take on a very different role: helping people invest their forced savings in a prudent manner.

This will come about through the combined pressure of regulation and the interest of employers. An employee who has lost his or her retirement benefits is a disgruntled employee, whether or not the benefits come from the employer's defined-benefit pension plan. As one increasingly sees in 401(k) plans in the post-Enron era, employers will take a firm hand in making portfolio allocations as stable and as unexciting as possible. This stance will drive employers to take a greater interest in their employees' financial lives.

If savings management largely morphs into customer education, there will be very little room for churning assets. Overall, I would expect the mass-market portion of the wealth-management industry to contract sharply, both in number of agents and in the number of asset-management firms with significant volume of transactions. The asset-management industry will likely be dominated by a modest number of large, low-margin entities like today's index funds, with a significant number of smaller specialty players. Active managers can kiss the retail sector goodbye.

Forced savings may have interesting macroeconomic implications as well. Forced savings do not represent a permanent reduction in consumption, but a deferral of consumption to later in the life cycle. However, at the time of implementation, there will be a temporary reduction in consumption that might persist for many years as the young build nest eggs and the old retrench.

Since the United States is the world's largest importer of consumer goods, this might have global ramifications. For example, China's growth is tied to spending by Americans. In addition, the pattern of consumption later in the life cycle will be different from what we see now. Perhaps big houses and fast cars will be replaced by cruises – or, more likely, high-tech medicine and low-tech assisted living. Certainly, understanding the consumption patterns of people aged 50 and above will prove very valuable.

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The State Fiscal Crisis

Why it happened and what to do about it

by Peter R. Orszag

State governments play a critical role in the nation's fiscal and economic system. They collect revenues on the order of 6 percent of GDP, or roughly a third as much as the federal government. They have long been responsible for key government functions that affect long-term economic growth as well as everyday life – notably, education and law enforcement. What's more, over the past two decades, devolution has given them expanded responsibilities in core areas like health care and welfare.

TOM NICK COCOTOS (ALL)

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STATE GOVERNMENT CURRENT RECEIPTS PER PERSON

	1990	2000	CHANGE
Personal income taxes	$495	$724	$229
Sales taxes	$766	$928	$162
Corporate taxes	$103	$117	$14
Other	$271	$357	$86
TOTAL	**$1,635**	**$2,126**	**$491**

STATE GOVERNMENT CURRENT EXPENDITURES PER PERSON

	1990	2000	CHANGE
General government	$98	$126	$28
Public order and safety	$137	$205	$68
Health	$481	$791	$310
Education	$275	$314	$38
Income security	$226	$258	$32
Other	$183	$212	$29
TOTAL	**$1,400**	**$1,906**	**$506**

NOTE: All figures are in 2001 dollars, using the GDP price index. Figures exclude grants from other layers of government.
SOURCE: Bureau of Economic Analysis and author's calculations.

The ability of state governments to meet their obligations is now threatened by yawning budget deficits. According to the National Conference on State Legislatures, projected deficits total $80 billion – about 15 percent of expenditures – for the fiscal year that began in July in most states. And after two years of budget nips and tucks, states have largely run out of easy options. They are now cutting health care for the poor, slashing higher education spending, releasing prisoners early and even unscrewing light bulbs to save on utility bills. These actions are harmful not only from a social perspective, but from a macroeconomic one. They are a sort of "anti-stimulus," reducing demand for goods and services just when the economy has capacity to burn.

The states' responses to this most-recent fiscal crisis differ from past efforts to close budget gaps. In the early 1990s, for example, states aggressively raised taxes to mop up the red ink. This time around, however, they have relied much more on spending reductions – with troubling implications for the ability of state governments to deliver crucial services like higher education. The $20 billion in emergency relief that was part of the recently enacted federal tax cut package will close only a modest portion of the states' fiscal gap.

The proximate cause of the state budget crisis is easy to pinpoint. The sluggish performance of the economy, combined with the bursting of the stock market bubble, significantly reduced state government revenue even as state outlays for Medicaid soared. But that is not the whole story. The states failed in their duty to accumulate adequate reserves during the boom of the 1990s, and Washington has no general countercyclical revenue-sharing program to help the states help themselves. Because of both what it has done and what it hasn't, Congress has shifted more costs to states – notably, through the Medicaid program.

THE BOOM

The stock market bubble and economic boom of the 1990s filled state coffers, just as they generated windfall revenues for the federal government. State income tax receipts rose particularly rapidly, driven by capital gains income and rapid growth in compensation among higher earners.

The states responded with a combination of tax-rate cuts, expenditure increases and reserve buildups. The Center on Budget and Policy Priorities calculates that state tax cuts enacted from 1994 through 2001 amounted to about 8 percent of state revenues, or about $40 billion annually. In other words, were it

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not for the tax reductions adopted during the 1990s, the state budget gap for this upcoming fiscal year would be roughly half its actual size.

Meanwhile, state spending per person rose from about $1,400 in 1990 to slightly more than $1,900 in 2000. But this was a slower rate of growth than during previous decades, while spending increases were concentrated in health care and prisons. Indeed, much of the increase was associated with Medicaid, which provides medical assistance to the low-

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income elderly and disabled, as well as to low-income families and pregnant women.

Medicaid cost increases during the 1990s reflected both general health care inflation and expansion in Medicaid enrollment. Expanded enrollment among the low-income elderly and disabled is particularly noteworthy, since these beneficiaries have relatively high health care costs and are typically also covered under the federal Medicare program. More than one-third of Medicaid outlays now pay bills for people covered under both Medicaid and Medicare.

The desire to cut taxes often trumped the virtue of saving for the future.

Medicaid finances items for these beneficiaries that are not covered under Medicare – in particular, prescription drugs along with a variety of deductibles and co-payments that are used to contain the cost of the Medicare program. As medical services have shifted toward outpatient, drug-based therapies and as the cost of prescription drugs has risen faster than the overall cost of medical care, costs have effectively been shifted from the fully federally financed Medicare program to the partially state-financed Medicaid program – and therefore from the federal budget to state budgets.

The states did use part of the revenue gains from the 1990s to add to rainy day funds and other reserves. These reserves are meant to smooth state expenditures and revenue over the business cycle, with money accumulating during booms and depleting during recessions. By the beginning of the 2001 fiscal year, states had accumulated almost $50 billion (or about 10 percent of one year's expenditures) in reserve funds.

Measured as a percentage of annual spending, these reserves amounted to about twice what had been accumulated before the 1990-1991 downturn. But they still weren't enough. One reason: many states set low limits on the size of their rainy day funds. Another reason was simply that the desire to cut taxes often trumped the virtue of saving for the future.

THE CRASH

Although they failed to prepare adequately for the downturn, state policymakers of the late 1990s could perhaps be forgiven for not foreseeing the magnitude or timing of the crash. After all, few leaders in business or the federal government did. State revenue was growing briskly. And while Medicaid costs continued to escalate more rapidly than population and inflation, they were increasing less rapidly than in the late 1980s and early 1990s.

But when it did come, the fiscal reversal proved particularly traumatic. Elaine Maag of the Urban Institute and David Merriman of Loyola University estimate that state revenue in the 2002 fiscal year was roughly $60 billion lower than a simple projection of previous growth would suggest. The decline was especially pronounced in income tax revenue, but sales tax revenue fell significantly, too.

Most of the decline in state revenue reflects the deterioration in both economic conditions and financial markets. Part, however, was driven by federal tax cuts. For example, the federal estate tax provides a credit against state estate and inheritance tax liabilities up to a limit, which varies with the size of the estate. Not surprisingly, every state imposes a "pickup" estate tax that is at least equal

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to this federal credit.

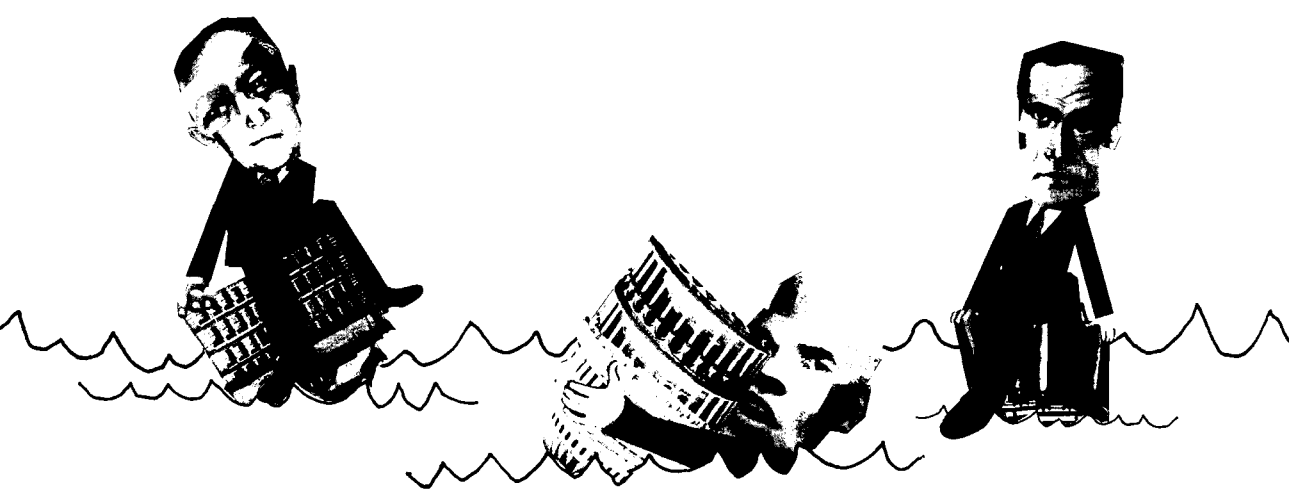
The credit had been transferring $5 billion or more per year from the federal government to the states without imposing additional tax burdens on estates. The 2001 tax cut, however, phases out the state estate tax credit between 2002 and 2005. Some states have "decoupled" their own estate taxes from the federal tax to preserve this source of revenue. But many others have not. Similarly, more generous corporate depreciation schedules and other tax cuts at the federal level will reduce state revenue unless states act to decouple from them.

Spending pressures intensified at approximately the same time that revenue dropped precipitously. The acceleration of health care costs, in particular drug expenditures, raised state Medicaid expenses substantially in 2002 and 2003. The National Association of State Budget Officers estimates that total state Medicaid spending rose by almost 12 percent in both 2001 and 2002 – about twice the growth in total state spending in those years and more than twice as fast as Medicaid spending had been rising in the late 1990s. General-fund deficits amounted to almost $40 billion in the 2002 fiscal year and about $80 billion in the 2003 fiscal year, and they are projected to reach $80 billion again in the 2004 fiscal year.

THE RESPONSE

The rapid appearance of deficits poses obvious problems for the states. Every state except Vermont has some sort of balanced budget requirement, though these requirements do differ in stringency. Some, for example, merely require that the proposed budget (as opposed to the implemented one) be balanced. States also employ various budget gimmicks, such as shifting the timing of payments from one fiscal year to the next, to skirt the balanced budget rules. Furthermore, most states have reserves that they can use to cover budget gaps.

When the state budget gaps first appeared, many states understandably tried to avoid immediate tax and spending changes. For example, 16 states closed at least a third of their 2002 deficits by drawing down reserve funds. Many also shifted significant revenue from the future – through securitization of payments they will receive from the legal settlement with tobacco companies – to help close current budget deficits. In other words,



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these states have effectively sold their rights to the future tobacco revenue in order to generate revenue today.

Continuing deficits, however, are increasingly eliminating the easier options available to state policymakers. In all but a handful of states, reserve funds have largely been exhausted. Moreover, when deficits persist over multiple years, accounting gimmicks that depend on shifting income or expenditures cease to work. Having largely exhausted their reserve funds and run out of loopholes in their balanced budget requirements, states are increasingly forced to take steps that impose political and economic costs.

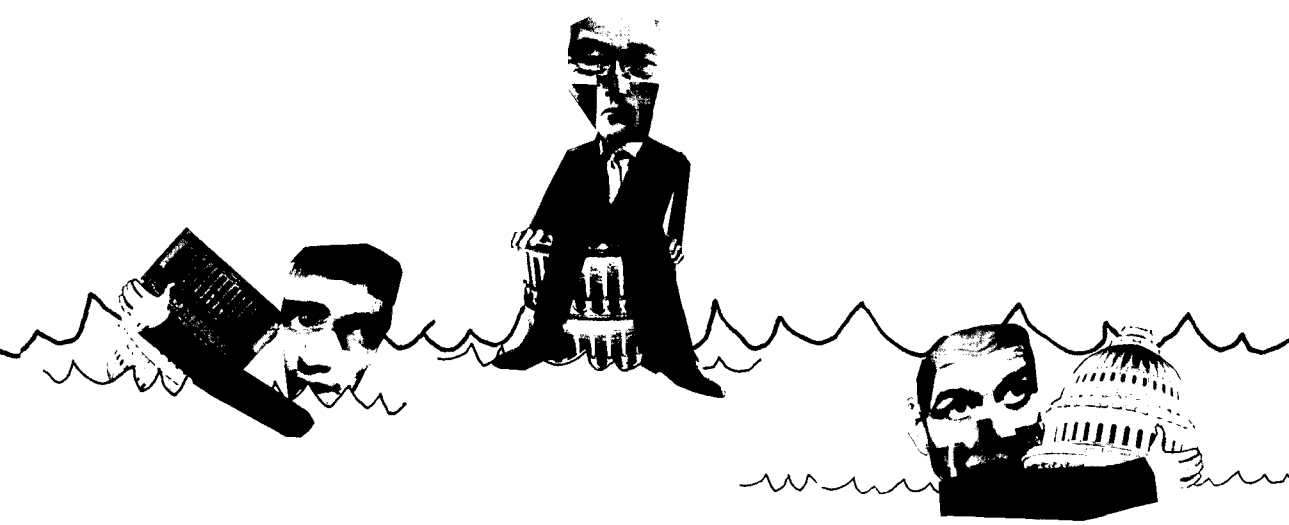
Data from the National Association of State Budget Officers suggest that real per person general fund spending fell by 1 percent in 2002 and by an estimated 2.3 percent in 2003. Several states have recently taken the unusual step of cutting spending for education in the middle of the school year, disrupting school plans. In most states, tuition for public universities and colleges has been raised substantially. Many states have slashed aid to local governments.

States have also begun raising taxes to help close the budget gap. But taxes are playing a much smaller role in addressing the current round of budget deficits than they did during the fiscal difficulties of the early 1990s. Maag and Merriman point out that if states had raised taxes as aggressively in 2002 and 2003 as they did in 1991 and 1992, they would have raised more than $30 billion in additional tax revenue in 2003. One reason for the difference is that more states now require more than a simple majority of legislators to approve tax increases. Arizona, Colorado, Nevada, Oklahoma, Oregon and Washington all added such supermajority requirements in the 1990s.

PAYING THE PIPER

The only real choices left to states at this point are cutting spending or raising taxes. Both are problematic in a sluggish economy, since both spending reductions and tax increases further reduce aggregate demand. In effect, the states are forced to exacerbate the economic downturn.

Contrary to the claims of some politicians, state tax increases are not more damaging in the short term than state spending cuts. Indeed, from a short-term macroeconomic



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The only real choices left to states at this point are cutting spending or raising taxes. Both are problematic in a sluggish economy.

perspective, tax increases geared to high-income households are the least harmful option. That's because taxing the affluent tends to reduce savings more than consumption. Note, too, that state income and property tax increases are partially offset by reductions in federal taxes, because state tax payments are generally deductible from federal taxable income.

By contrast, reductions in state government purchases or transfer payments to lower-income families living from payday to payday are likely to drill a bigger hole in total spending. And spending, public and private, is the key to short-term growth in an economy with excess productive capacity.

Whatever their short-run economic effects, spending reductions and tax increases intended to meet immediate fiscal challenges may play out in unexpected ways. A good example involves higher education, which has historically tended to be among the most cyclical of state budget categories.

As the economy entered a recession in the early 1980s, appropriations for higher education declined in real terms. Then during the recovery of the mid-1980s, appropriations recovered and ultimately exceeded their prerecession peak. However, something was quite different during the economic cycle of the 1990s. As the economy slid into recession in the early 1990s, real appropriations per person again declined. But during the boom of the 1990s, appropriations for higher education rose only slightly and never reached their prerecession levels.

Moreover, the decline in state appropriations for higher education has been offset only partially by increases in tuition. As a result, spending per student at public universities has plummeted compared to spending per student at private universities.

My own research in collaboration with Thomas Kane of UCLA shows that, across

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states, Medicaid plays an important role in explaining the difference in higher education financing between the 1980s and the 1990s. Our results suggest that the current round of reductions may prove to be a permanent ratcheting down in state support for higher education rather than a temporary adjustment in response to cyclical fiscal problems.

After a protracted political tussle, Congress decided to offer the states some help. The 2003 tax cut included $20 billion in state fiscal relief, half of which is effectively allocated on a per capita basis and half as a temporary increase in the federal share of Medicaid costs. It's worth noting, though, that Congress is also undermining the states' revenue base; the 2003 tax cut included provisions that will reduce state revenue unless the states decouple their tax codes from the federal statute.

Federal assistance is, of course, welcome, but the initiative won't solve either the immediate problem or the longer-term one. To avoid future fiscal crises, states need to explore ways of minimizing the variability of their budgets over the business cycle and to address structural imbalances between expenditures and revenue.

States need to explore ways of minimizing the variability of their budgets over the business cycle and to address structural imbalances between expenditures and revenue.

SMOOTHING THE FISCAL CYCLE

Three steps would help states better smooth their budgets over the business cycle. First, they need to put away more cash in good times. Policymakers must keep rainy day savings high on the agenda, which won't be easy once the sense of crisis fades.

The rules governing reserve funds should also be changed. In 19 states, money added to rainy day funds cannot exceed 5 percent of annual state spending. That is clearly inadequate to meet a sustained fiscal crisis. States have the option of saving money outside their rainy day funds – but that hardly justifies retention of the caps on the rainy day funds themselves.

In addition, in most states the rules requiring contributions to reserve funds are not adequate to inhibit politicians' natural proclivity to dissipate funds immediately. Such institutional barriers to the accumulation of reserve funds should be changed.

Second, states need to redesign their tax systems with an eye toward minimizing revenue volatility. For example, if income and sales are not perfectly correlated across the business cycle, taxing both can reduce the variability of the total take. Unfortunately, given the relatively high correlation in the relevant tax bases, the gains from such diversification are modest.

Adjusting the tax system to reduce variability in revenues may also conflict with the goal of fairness. A less progressive income tax, for example, tends to be less sensitive to changes in income. By the same token, a sales tax that does not exempt food tends to be less variable over the business cycle, but is more regressive than a narrowly based sales tax.

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Third, in light of the practical limits to diversifying state revenue bases, Washington should lend a hand in more systematic fashion. Alice Rivlin of Brookings has proposed automatic federal grants based on national or state economic indicators during recessions. The danger with such a program is that it may discourage states from building up their own reserve funds; hence the revenue-sharing formula should be designed with the states' incentives in mind.

For example, the federal program should cover only a limited share of budget gaps, leaving states with very good reasons to make their own rainy day plans. The program could also be limited to states that have adopted a model set of rules for their reserve funds. And carrots could work along with sticks; the federal formula could include matching funds for state reserve fund accumulations.

The formula for disbursing funds could also reflect the estimated effect of economic changes on the state's revenue. States that cut tax rates during the boom would then receive less than other states that had not.

STRUCTURAL CHANGES

Even if state budgets were designed for a smoother ride over the business cycle, one big problem would remain: In the absence of policy reform, state budgets are likely to come under continued pressure from increased Medicaid costs and from further erosion of their own tax bases.

The population aged 65 and over is expected to increase from 35 million in 2000 to 70 million by 2030. The low-income elderly are eligible for Medicaid, implying that the number of elderly beneficiaries will rise rapidly in the future. Two components of health care for the elderly loom especially large for Medicaid: long-term care and prescription drugs.

In 2000, Medicaid financed nursing home care for more than two-thirds of nursing home residents; these expenses represented about one-quarter of total Medicaid payments. According to the Urban Institute, Medicaid's long-term care costs are projected to double in real terms over the next two decades. And as noted above, costs are being shifted from Medicare to Medicaid as health care increasingly moves toward outpatient services and prescription drugs.

While the process will be painful, reforms to both Medicaid and Medicare are crucial to the future fiscal soundness of state governments. In designing reforms, moreover, it doesn't make sense to reduce the expected costs for the states while making them responsible for a much larger share of the risks involved. Because of their balanced budget rules, narrower revenue bases and more limited borrowing ability, states are much less able to bear such risks than the federal government.

One way or another, states must also address the ongoing erosion of their revenue bases. William Fox of the University of Tennessee estimates that sales subject to state tax have declined from 51 percent of personal income in 1979 to 42 percent in 2001. The corporate income tax base has also been eroding, with roughly half of the decline at the state level reflecting a narrowing of the federal corporate income tax base.

A LAST WORD

Many of these ideas have been on the table before – and there are good political reasons that constructive changes have rarely been made. One can only hope, though, that the wrenching dislocations now under way will change the political calculus of state budgeting – and that enlightened politicians will seize the day.

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Despite <The Dynamics of Scoring>

A Congressional Tale

by Rudolph G. Penner

MICHAEL SIPE

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what you think,

the most important form of scoring in Congress has nothing to do with sex.

Every bill reported out of committee must be scored – that is, its potential impact on government revenues and outlays estimated. The Joint Committee on Taxation considers bills that affect major revenue sources, while the Congressional Budget Office scores bills' spending impact along with revenues from less important sources like import tariffs. And though the process seems dull on first consideration – I know, you're already wondering whether to flip to the next article – budget scoring can make a world of difference in how we are taxed and how much is spent.

Hence, the analysts who labor deep in the background to produce scores are extremely powerful. A prime example: the recent tax cut.

The Senate had decreed that changes in tax policies would not be allowed to increase the budget deficit by more than $350 billion over the next 10 years. To meet the target, the bill was trimmed to fit, with phase-outs, phase-ins and sunsets that would make an Enron accountant blush.

Although the contortions in the tax law were particularly outrageous this year, it is common to rejigger policies to produce scores that meet Congressional spending or revenue targets, or that satisfy

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some budget rule. Indeed, if a policy initiative cannot be shoehorned into a preagreed numerical limit, it is likely to die.

As a result, those favoring a bill press the analysts to assign as low a cost as possible to it, while opponents like to see its costs exaggerated. Lobbyists watch the process carefully, hoping to find analytic errors if a score goes against them – or to persuade analysts to adopt assumptions favorable to their cause before the analysis begins. During my tenure as the CBO's director, criticism of our economic forecasts and estimates of budget aggregates was tempered. But more than once I had to hold the phone away from my ear when listening to a member of Congress who claimed that our scoring methods had destroyed some pet initiative that, but for our stupidity, would save the nation.

In spite of these pressures, the process proceeds with remarkable integrity. CBO and Joint Committee on Taxation analysts almost always work objectively, regardless of the political consequences.

Indeed, because scoring can be so controversial, the CBO has laid down explicit rules defining what's right and what's wrong. This ensures that analysts will score on a consistent basis – and that the office will be protected against charges of bias. But most of the rules do contain arbitrary elements. Some are pragmatically designed to ease the task, so that scores can be produced quickly. And some are affected by in-house politics. For example, scoring rarely takes account of the effect of one committee's actions on the costs of programs in another committee's jurisdiction.

One rule particularly annoys supply-siders and other fervent tax cutters: scorers do not take account of some indirect macroeconomic effects of tax changes on revenues or spending. In particular, supply-siders argue that if the positive effects of tax cuts on economic growth were factored in, the revenue losses would be much lower than conventionally scored.

Many outsiders charge that the failure to account for indirect macroeconomic effects implies that scorers pay no attention to the impact of policy on human behavior. Critics refer to conventional scores as "static" – and thus inherently inferior to dynamic estimates. Actually, scorers do take account of *microeconomic* behavioral responses to policy changes. For example, the revenue estimates associated with an increase in the gasoline tax would take account of the likely decline in gasoline consumption when the price goes up. Changes in the capital gains tax rate are assumed to affect the timing and volume of asset sales. And so forth.

However, analysts do stop at the water's edge; these micro responses are implausibly assumed to have no effect on total economic output, inflation, unemployment or other macroeconomic variables that feed back on government spending and revenue. If

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I often had to hold the phone away from my ear when listening to a member of Congress who claimed that our scoring methods had destroyed some pet initiative that, but for our stupidity, would save the nation.

pressed, the analysts may say they do not bother because the Federal Reserve will offset relevant macro effects. But the real reason that macro responses are not considered is purely pragmatic: dynamic scoring is just too time-consuming and too hard to coordinate.

Analysts must routinely contend with complex provisions that affect both revenue and spending. Dozens of analysts working both at the Joint Committee on Taxation and the CBO may be involved in scoring one bill, each focusing on a subset of its provisions. What's more, they sometimes have only hours to complete their task.

Assumptions about GDP growth and inflation have a crucial impact on estimates of the revenue effects of tax changes. The macro assumptions are generally provided by CBO's annual economic forecast. This forecast is completely dynamic in that it considers the consequences of all behavioral responses to the policies in effect when the forecast is made.

Think, too, of the dimensions of the coordination problem. Ideally, any change in the macro forecast made by analyst A would affect the estimates of analysts working on most other provisions of the legislation. If, after A makes an estimate, and B decides that her provisions affect the macro economy, too, A should go back and redo his own estimate to maintain internal consistency. And that's only the beginning; changes in the macroeconomic environment should change cost and revenue estimates throughout the budget – even for programs not directly affected by the policy change. In other words, the whole budget base line should be re-estimated every time a significant bill passes.

Even if that were practical it would drive Congress crazy, because ever-changing cost estimates would disrupt negotiations and force the revision of deals that had been made before the estimates changed. CBO used to provide a baseline in the spring and update it in the summer. But even that arrangement proved cumbersome. So, in 1985, Congress directed the agency to stick with its spring baseline all year for purposes of scoring, regardless of how inaccurate it became.

The complexities of dynamic scoring might still be manageable if Congress allowed analysts a couple of weeks to do their work. But often CBO must come up with estimates the day after they are requested, and that makes adequate dynamic scoring logistically impossible.

It is obviously absurd to argue that the Congress should therefore be shielded from knowledge of the effect of major policy changes on economic growth, inflation and unemployment. When requested, the CBO has done comprehensive dynamic analyses of important hypotheticals like capital gains tax changes,

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but the process takes months and is thus hard to link to specific legislation. Remarkably, Congress has seldom asked for such studies.

When the Republicans took control of both houses of Congress and supply-siders gained leadership roles, the pressure grew to do some sort of dynamic scoring of tax bills. The House first passed a rule saying that dynamic analyses could be requested for specific tax bills. But more recently, it ordered the Joint Committee on Taxation to estimate the effects of *all* tax legislation on economic growth, or to inform the House why such estimates were not practical. The first full-blown dynamic analysis by the Joint Committee on Taxation was performed for the House tax bill of 2003.

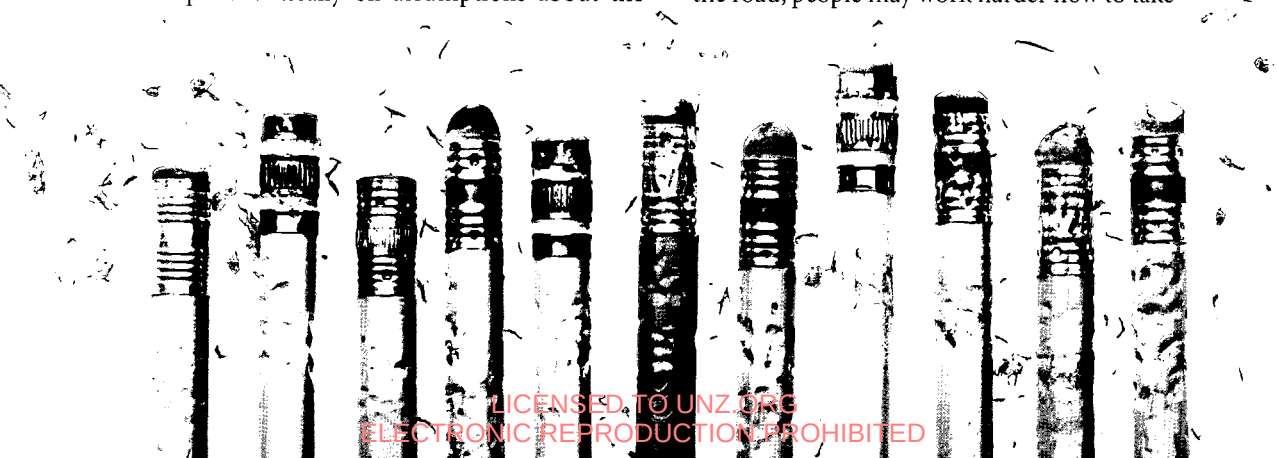
Note that the rule states dynamic analysis is for *informational purposes* only. That is, the analysis will not be used to enforce numerical targets created in the process of hammering out a budget. A purist would say, therefore, that it is not really dynamic scoring, but just analysis that complements scoring-as-usual. This distinction may seem a nitpick. However, it has important implications for how the analysis is done – a point I shall come back to.

To improve the quality of its dynamic analysis and to foster consensus, the Joint Committee created an advisory body of economists from both political parties and with diverse ideologies. But that is a daunting goal, because estimates of the effects of tax changes depend critically on assumptions about the behavioral responses of both investors and consumers on the one hand, and the Federal Reserve on the other.

To deal with such thorny issues, the House rule gives the scorers a luxury that they do not usually enjoy. Because the analysis is not an official scoring exercise, analysts can offer a range of estimates rather than the single number demanded in traditional scoring. For example, the JCT provided different results for different assumptions regarding the Fed reaction to the tax-cut initiative and analyzed the policy change using different models of the economy. In one variant, the Fed raised interest rates, thus washing out a large portion of the demand-side stimulus associated with lower taxes. In others, the Fed created enough liquidity to accommodate differing portions of the demand effects.

The assumptions in the economic models used by the JCT differed in a number of respects, but one of the key factors was the extent to which households and businesses reformulated their own forecasts in response to changes in government fiscal policy and how they responded to those forecasts. Economic actors may be totally myopic, not worrying about the affect of federal tax changes on variables ranging from interest rates to inflation. On the other hand, people may recognize that a tax cut today probably means higher taxes or lower government spending tomorrow to counter the effect on the deficit.

If higher taxes are indeed expected down the road, people may work harder now to take



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A whole branch of economic theory has been built on the idea that fiscal and monetary policy have little or no net effect because producers' and consumers' knowledge of the long-term consequences leads them to behave in ways that fully offset the impact.

advantage of temporarily low rates and enjoy more leisure later when rates are again raised. They may also save more now to prepare for paying future tax increases. Indeed, a whole branch of economic theory has been built on the idea that fiscal and monetary policy have little or no net effect because producers' and consumers' knowledge of the long-term consequences leads them to behave in ways that fully offset the impact.

In all the models used by the JCT, the tax-rate cuts had both positive and negative effects on economic growth. They increased productive capacity because lower tax rates increased incentives to work, save and invest. Moreover, this supply-side effect was complemented by a positive effect on demand that varied in importance, depending on the assumptions.

On the other hand, the increased deficit that resulted from tax cuts reduced national savings and capital formation. Tax cuts taking the form of tax credits also had a negative impact – the resulting income is like a no-strings-attached gift, and thus provides no extra incentive to work. In fact, research suggests that lump-sum income gains reduce work effort – especially among second (and third) earners in a household.

The Joint Committee on Taxation estimated that in the first five years the positive effects of the tax cut would dominate. In later years, the negative effects of the deficit became relatively more important as the resulting slowdown in capital formation begins to bite. And after all the brouhaha over giving supply-siders a new peg to hang their hats, dynamic analysis made little difference, on balance. The House tax bill was projected to raise real GDP by something on the order of 0.2-0.9 percent between 2003 and 2008, and lower it by a maximum 0.2 percent between 2009 and 2013.

The reduction in the estimated loss of revenue resulting from dynamic analysis of the tax cut was similarly disappointing to proponents. For the 2003-2008 period, the budget savings ranged from 5.8 to 27.5 percent, depending on the model and assumptions used. Over the entire 2003-2013 period the savings ranged from 2.6 to 23.4 percent.

In March 2003, the CBO provided a dynamic analysis of the Administration's whole budget, including spending as well as tax proposals. Although the analysis also provided a wide range of results, the average differed little from zero. The estimated cumulative deficit from 2004 to 2008 ranged from $1.24 trillion to $1.04 trillion, compared to a traditionally computed estimate of $1.16 trillion.

Being able to provide a range of estimates greatly eases the analyst's task. I am

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It is something of a game – one that brings some discipline to the budget process when it is played well. In recent years, though, the game has not been played well.

sure they would like to provide a range for static scores as well, but Congressional rules require a single number. Thus, when confronted with a range of estimates for, say, the demand response to an increase in the gas tax, analysts must choose just one.

There are differences between what was done by the JCT and the CBO and a comprehensive dynamic analysis. The agencies did not go back and re-estimate the revenue effect of specific provisions of the bill, given different macro results. They also did not provide year-by-year estimates, and they made no effort to recompute the whole budget baseline for different macroeconomic responses. All that made the task much easier. It does mean, however, that the results are not quite internally consistent.

How can we expect tax-cut enthusiasts to respond to this less-than-meets-the-eye result? Their first line of attack will be to argue that the JCT and CBO analysts used the wrong models and made the wrong assumptions. They will argue for assumptions that enhance the positive supply effect of tax-rate cuts and minimize or delay the negative impact of deficit increases. However, if the scorers do not use assumptions consistent with the precepts of mainstream economics, they will lose credibility. And credibility is their only asset.

The center of the economics profession may, of course, move to accommodate the supply-siders. If dynamic analysis had been performed 30 years ago, the focus would have been on demand effects, while the supply side would have largely been ignored. Now the worm has turned. Economists seem more confident of supply-side effects than they are of the impact on demand. This drift toward the right may well continue, but such changes generally proceed glacially.

I suspect that the Congress may tire of dynamic analysis long before its results become more favorable to tax cutters – if they ever do. And Congress will tire of the effort more quickly if the JCT pursues the task aggressively. After all, a large portion of the tax cuts considered by Congress are clearly hostile to economic growth. The cuts often favor one industry or group over another, thereby distorting the allocation of labor and capital, and making the economy less productive. If I'm right, the rule requiring dynamic analysis is likely to quietly disappear.

Although the contretemps over dynamic scoring has been educational, it has diverted attention from much more serious problems with the current scoring process. For example, important distortions result from using a 10-year time horizon that scores the impact for the 11th year as zilch. These distortions are particularly serious when considering changes in the taxation of capital income.

Take the case of individual retirement accounts that give owners some relief from taxation. Under reasonable assumptions, the present value of the revenue loss associated with traditional IRAs (where deposits are deducted from current taxable income), is the same as the loss from Roth IRAs, where deposits are not deductible but the income

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generated over the life of the account is never taxed. But the costs are all backloaded; for the first 10 years, Roth IRAs cost the Treasury less – which explains why Congress created them. Conversely, an increase in the generosity of investment depreciation allowances, which defer the payment of taxes, reduces revenues more in the short run than in the long run. In all such cases, we should be willing to consider scores consisting of present values computed over very long time horizons.

The rules of scoring also produce very misleading results in some, albeit rare, odd cases. For example, scores do not take account of changes in the interest owed each year on the public debt. Thus, although a tax cut increases the deficit and so adds to the interest burden, the latter is not counted in the official score. Most of the time, this omission does little harm – but it obviously should be considered in comparing a temporary tax cut to a permanent one.

Rules can also have weird effects on scores for minor policy proposals. Consider the curious case of a proposal to replace the dollar bill with a coin. The official score in this case took account of the fact that since coins last much longer than bills, it would cost much less to manufacture the needed amount of currency. But it did not take account of the reality that it takes more than one coin to replace each bill because, among other things, people tend to throw coins on dressers at night and leave them there.

Nor did it account for the potential savings in interest payments on the federal debt. If deficits can be financed in small part by the distribution of new coins (as opposed to selling government bonds) the interest saving ought to be a significant part of the scoring calculation. But CBO is not allowed to count interest savings in its scores.

In this case, CBO estimated the interest savings for informational purposes only, much as the new House rule provides information on the growth effects of tax cuts. But that did not placate organizations of the blind, vending machine operators, and others who support the transition to coins. They were rightly annoyed that an important component of the savings from their proposal was omitted from the official score.

I do not wish to leave the impression that bizarre results are common. But odd examples do reveal that a lot about scoring is close

to arbitrary. It is something of a game – one that brings some discipline to the budget process when it is played well. In recent years, though, the game has not been played well.

As noted earlier, a number of swing-vote senators forced the Republican leadership to limit the tax cut to $350 billion in the 2004 budget. But that target was attained only with an array of phase-outs, phase-ins and sunsets that made a mockery of the $350 billion limit and undermined the tax cut's potential to stimulate work, investment and, ultimately, economic growth. The distortions introduced by such shenanigans make aberrations in scoring rules and the absence of dynamic scoring seem a trivial problem.

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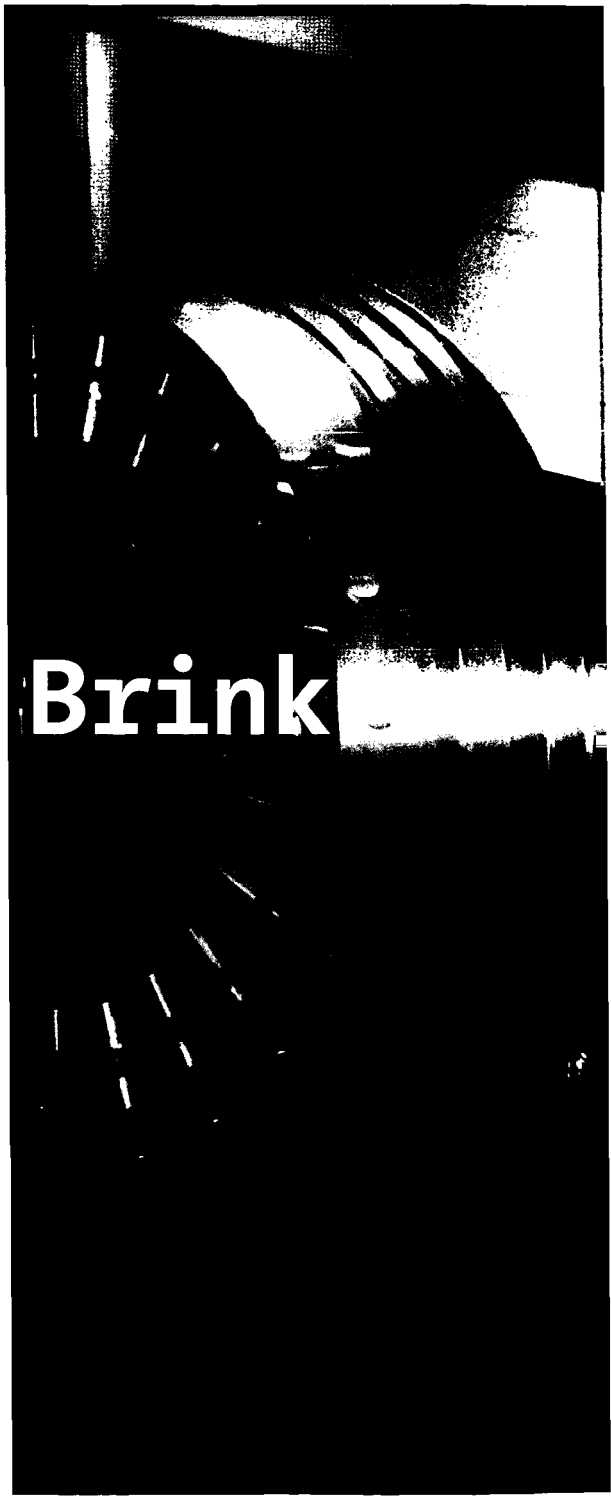
Can China Fix its Banking System?

Reformers at the Brink

by Marsha Vande Berg



China's new rulers are circling around what could prove the toughest challenge of their reign – reform of the state-run banking system and the crony Socialist system for allocating capital. They are taking steps to repair the balance sheets of major banks, which are groaning under the weight of billions of dollars in dud loans. And they must manage the process in ways that sustain the credibility of the Communist Party.

It didn't help, of course, that Beijing

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has had its hands full coping with the SARS epidemic, which hit China just weeks after the change of government. Nor did a less-reported event (though one more relevant to the financial challenge): a bank-corruption scandal that spread from Hong Kong to Shanghai. There is little reason to believe, though, that either will sidetrack the reform effort.

In fact, the bank scandal could work to the reformers' advantage, promoting awareness that the key to modernizing the economy is to limit political interference in the banking system. "These are short-term crises. They're opportunities to make improvements, including the transparency of loan processing," argued a portfolio manager with Matthews International Funds in San Francisco.

Uncertain times also afford the government an opportunity to switch its focus to banking reform and away from last year's preoccupation with the equity markets – the latter viewed by some as "casino capitalism." To this end, the new leadership has created a bank regulatory commission, placing Liu Mingkang, a respected bureaucrat with a reputation for intolerance of corruption, at the helm.

The new energy behind reform could also lead to a third infusion of capital to shore up China's Big Four commercial banks (the Bank of China, the Industrial and Commercial Bank of China, the China Construction Bank and the Agricultural Bank of China) along with the transfer of nonperforming loans from the banks' books to special "asset management companies." These companies, set up in 1999, are similar in function to the government agency that collected the low-grade

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Business as usual will undermine China's long-term growth prospects because state-owned banks continue to direct valuable capital to state-owned enterprises, however inefficient.

assets from bankrupt institutions during America's savings and loan crisis in the 1980s.

To date, the Big Four have transferred loans and stock with a nominal value of a whopping $169 billion to four asset management companies. Purchasers of chunks of these assets (at huge discounts, of course) include Goldman Sachs. There is also a plan to set up similar asset-transfer entities to bury nonperforming loans on the books of companies owned at the provincial and local levels.

Yet, despite the range of reform-related activities, the government is still poking around the edges. "Instead of persisting with the present 'muddling through' approach, China's new leaders should go for a 'big bang.' Otherwise the flourishing economy that they have inherited could soon find itself in trouble," Fred Hu, managing director of Goldman Sachs, explained in an article published in *The Financial Times*.

For Beijing, the issue seems to break along two lines. On the one hand, the leadership is committed to driving reforms in order to defend the legitimacy of Party-controlled government. On the other hand, it is deeply reluctant to upset the status quo – especially in ways that alienate the Party's core supporters in northern industrial cities, where tens of millions of jobs still depend on the viability of state-owned enterprises.

Loans currently on the books of the state-owned banks exceed $1 trillion. Of that total, the government says, roughly 25 percent are non-performing. Outside estimates suggest the percentage of non-performing loans could be as high as 50 percent, but at least everyone agrees the figure is dropping.

Some argue that the situation is not as grave a threat to China's payments system (and ultimately, China's drive for prosperity) as it first appears, because the Chinese government guarantees most of the bank debt and has considerable assets (not to mention the power to print money) to make good on bank liabilities. However, failure to clean up the banks' balance sheets could damage the confidence of foreign investors who poured $52 billion (along with vital industrial technology) into the Chinese economy last year in the form of direct investment.

More fundamentally, business as usual will undermine China's long-term growth prospects, because state-owned banks continue to direct valuable capital to state-owned enterprises, however inefficient. Indeed, it is a mistake, in the view of Linda Tsao Yang, a former governor at the Asia Development Bank, to view the Big Four banks – with 80 percent of the market – as real banks. "In principle, yes, they were set up as banks," she said. "But in recent years, especially with the opening up

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Even the modest shift to date in lending that favors consumers has resulted in a mini-boom for second-tier commercial banks.

under the rules of WTO, their real function is to avoid a massive loss of jobs. Any change, no matter how desirable, if it's seen as upsetting, will trigger an effort to slow reforms down," she added

Meanwhile, the clock continues to tick on China's obligation to meet accession terms with the World Trade Organization. The phase-in period is scheduled to expire in 2007, at which time a liberalized Chinese economy, including the reformed banking sector, is expected to open up to foreign competition. At that point, foreign banks will be able to lend and take deposits, denominated in Chinese currency, from Chinese individuals and firms – which they now are barred from doing. If China's state banks are still sitting on a mountain of bad debts when the deadline rolls around, they will be in no position to hold onto the deposits that have thus far allowed them to scrape by.

The creation of the regulatory agency with Liu in charge is certainly a promising step toward fiscal daylight. However, a close look at the agency's structure suggests that its prospects for success still depend on a decisive break with the legacy of China's socialist past. And such change would be quite a stretch for an institution so tightly linked to the banking establishment.

Ostensibly, the regulatory agency has taken over the central bank's direct regulatory function, leaving the People's Bank of China with responsibility for monetary policy. That independence seemed critical if bank regulators were to challenge the power of the banks.

But something slipped 'twixt cup and lip. At the time of its founding, the agency was also charged with managing the personnel of state-owned banks. This had been the responsibility of the Central Financial Work Commission, an entity set up by the then-premier, Zhu Rongji, and run by Wen Jaibao, then vice premier and now premier. The commission's authority flowed from the government.

It is far from clear that a reform agency with bank management responsibilities can work effectively to decentralize authority in ways that allow it to operate effectively in a competitive market. On the other hand, this is China, which does things its own way. The development of the agency along these lines simply illustrates the nature of the reorganization that is underway, says Barry Naughton, a China specialist at the University of California at San Diego. It's indicative of "government reorganization in general: deliberate, delayed and complex, yet still moving," Naughton wrote in a recent issue of the online *China Leadership Monitor.*

But can it succeed? The institutional history of the banking sector offers clues. Today's banking system emerged from a highly centralized unitary banking institution that was both a central bank (with authority to issue currency and implement monetary policy) and a commercial bank, providing deposit, loan and settlement services.

The PBC was established in 1948, when three regional banks were assembled under

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the control of the Chinese Communist Party. The new entity worked with the Ministry of Finance under the State Planning Commission to sustain party control, following guidelines set by Beijing's central planners. It not only ran the banking system, but served as insurance regulator and underwriter.

In the mid-1950s, the banking sector expanded along with the Chinese economy. The Bank of China was set up under the PBC, while the People's Construction Bank was formed under the control of the Ministry of Finance. The Bank of China was responsible for foreign-exchange activities, while the Finance Ministry supported domestic construction and other fixed investment. Rural Credit Cooperatives were also created to take deposits and allocate funds in China's diverse agrarian economy.

Both the Bank of China and the Construction Bank were run as departments within government agencies – as opposed to independent entities – until the reforms of late 1983 and 1984. At that point, Beijing began to regard the PBC as its central bank.

From the beginning, these banks operated within numerous non-market constraints. Party officials and bureaucrats, as well as the formal government authority, looked to the banks to support the industries and enterprises that supported the ruling elite. And in some senses, not much has changed: local officials' fate remains tied closely to the survival of state-operated businesses in their jurisdictions.

Any restructuring in the financial sector, then, has the potential to interfere with party patronage and government control at the grass-roots level. And that is bound to be painful in a system devoted to busywork. Management reforms in the state banks alone cost 300,000 jobs in the late 1990s.

But others will benefit greatly from the opening up of the buttoned-down system.

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For example, even the modest shift to date in lending that favors consumers, especially in the areas of home mortgages and automobile purchase finance, has resulted in a mini-boom for second-tier commercial banks.

These second-tier banks, which include shareholding banks with less than 15 percent foreign ownership, are majority owned by local governments or state-owned entities. The exception is China Minsheng Bank, which is majority owned by the Orient Group conglomerate. Minsheng's net profit jumped 43 percent during the first quarter of 2003, to $34 million, largely because of its success in financing private auto and housing ownership.

Shareholding banks tend to avoid loans to state-operated businesses, which means their portfolios are likely to be in much better shape than those of state banks – as is the case with Minsheng Bank. A recent report by the London-based Royal Institute of International Affairs speculated that these shareholding banks will merge and acquire urban banks – of which there are about 100 – to expand their branch networks.

While these smaller Chinese banks welcome foreign investors with open arms for the expertise they bring to technology and management, foreign banks have more ambitious plans. They are eager to position themselves to leverage their investments in the core of the banking market, once the reins come off in 2007.

Notable examples include HSBC Bank, which bought an 8 percent stake in the Bank of Shanghai in late 2001, and Citigroup, which purchased a 5 percent stake in Pudong Development Bank in early 2003 and subsequently obtained an option to increase that holding to a controlling interest in the future.

Foreign investors are being allowed to compete, but based on rules – some of which are very rigid – designed to ensure that foreign banks do not destabilize the sector. "It's a matter of having been in the market in China for a long time," says a high-placed Citigroup official. "We're trusted. We have a reputation of seriously supporting China in the global economy."

In contrast to the arrangement in Pudong, an investment in the Shenzhen Development Bank by Newbridge Capital, an American equity firm, now appears to be in limbo after Newbridge's China partners booted a management committee made up of Newbridge representatives. The partnership is now the subject of a lawsuit brought by Newbridge in a federal court in Texas against Taiwanese interests, alleging they interfered in the arrangement with Shenzhen Bank.

As is often the case in today's China, change can hinge on the influence and stature of a single individual – in this case, Liu Mingkang.

At the time it was announced, the Newbridge deal was heralded as a breakthrough in United States-China joint ventures and as a sign that China was committed to increased Western participation in the banking sector. And some now view the developments around the Newbridge investment as an important setback to foreign investors' confidence in doing business in China.

But others dismiss the unraveling as an

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anomaly rather than a harbinger. They point to the corruption investigation into one of China's wealthiest individuals and his relationship with the Bank of China (Hong Kong) that erupted in June as off-putting to Western business. "The scandal definitely will hurt investment sentiment, at least in the short term," said the portfolio manager with Matthews International Funds. In the longer term, progress with reforms will overtake these kinds of problems, he added.

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As is often the case in today's China, change can hinge on the influence and stature of a single individual – in this case, Liu Mingkang. Liu recently announced that he intends to secure a 3 to 4 percent improvement in the ratio of bad loans to GDP in the next several months. He made the announcement in an unusual setting for a Chinese official – a press conference.

Liu brings a great deal of credibility to the table. In the past, he has been put in charge of banks when corruption scandals threatened to destroy credibility in the banking system and undermine the authority of those who sit in Beijing. Three times, he oversaw massive cleanups – including twice at the Bank of China.

In 2000, he was named chairman of the Bank of China, succeeding Wang Xuebing, whose banking career imploded spectacularly following United States regulators' claim of improper banking practices at the Bank of China's New York branch. The following year, Liu restructured 13 affiliated Hong Kong branches of the Bank of China as a coherent unit, which subsequently became Bank of China Hong Kong.

In July 2002, he shepherded through a public offering of Bank of China Hong Kong on the Hong Kong stock exchange. The offering was successful, raising $2.63 billion when the parent, Bank of China sold 22 percent of its ownership. At the time, the auction was watched as a trial run for stock market listings of three of the Big Four banks, including the Construction Bank of China and the Industrial and Commercial Bank, by 2005.

Liu was quoted by Bloomberg as believing that "time is running out for the banks." If he is to succeed with his stated intention to cut the ratio of non-performing loans at China's big banks, he will need the cooperation of other reformers in Beijing and throughout the provinces.

If time is indeed short, China's reformers will have to ask themselves why they squandered valuable momentum. But even if Liu is just posturing, the government will have to figure out ways to keep political interests at bay while it brings the county's system for allocating capital into the 21st century. The country's future – not to mention the future of the Party – depends on it.

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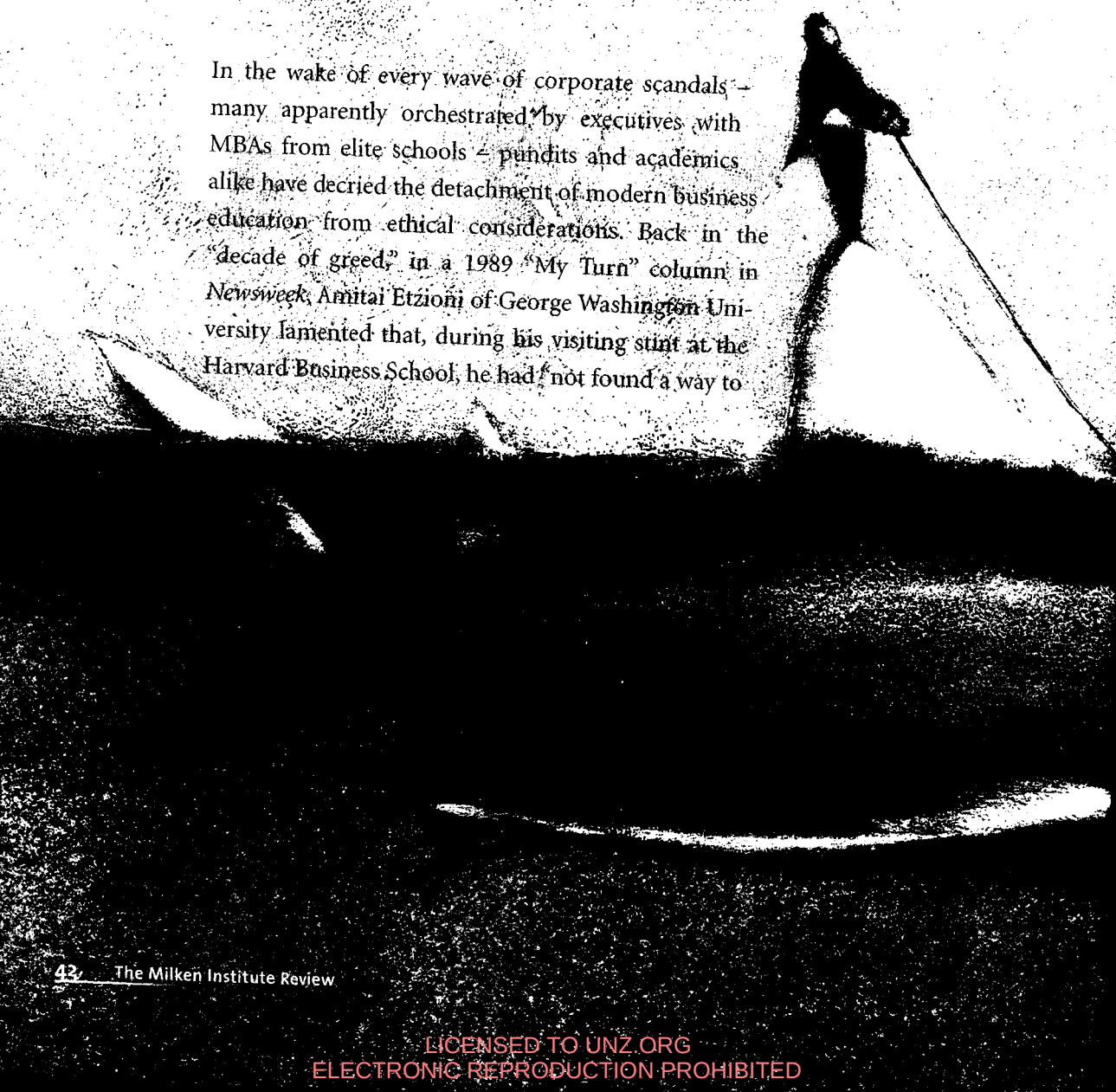
Jaw-

Business Ethics

You can lead a shark to water...

by Richard B. McKenzie and Tibor R. Machan



In the wake of every wave of corporate scandals – many apparently orchestrated by executives with MBAs from elite schools – pundits and academics alike have decried the detachment of modern business education from ethical considerations. Back in the "decade of greed," in a 1989 "My Turn" column in *Newsweek*, Amitai Etzioni of George Washington University lamented that, during his visiting stint at the Harvard Business School, he had "not found a way to

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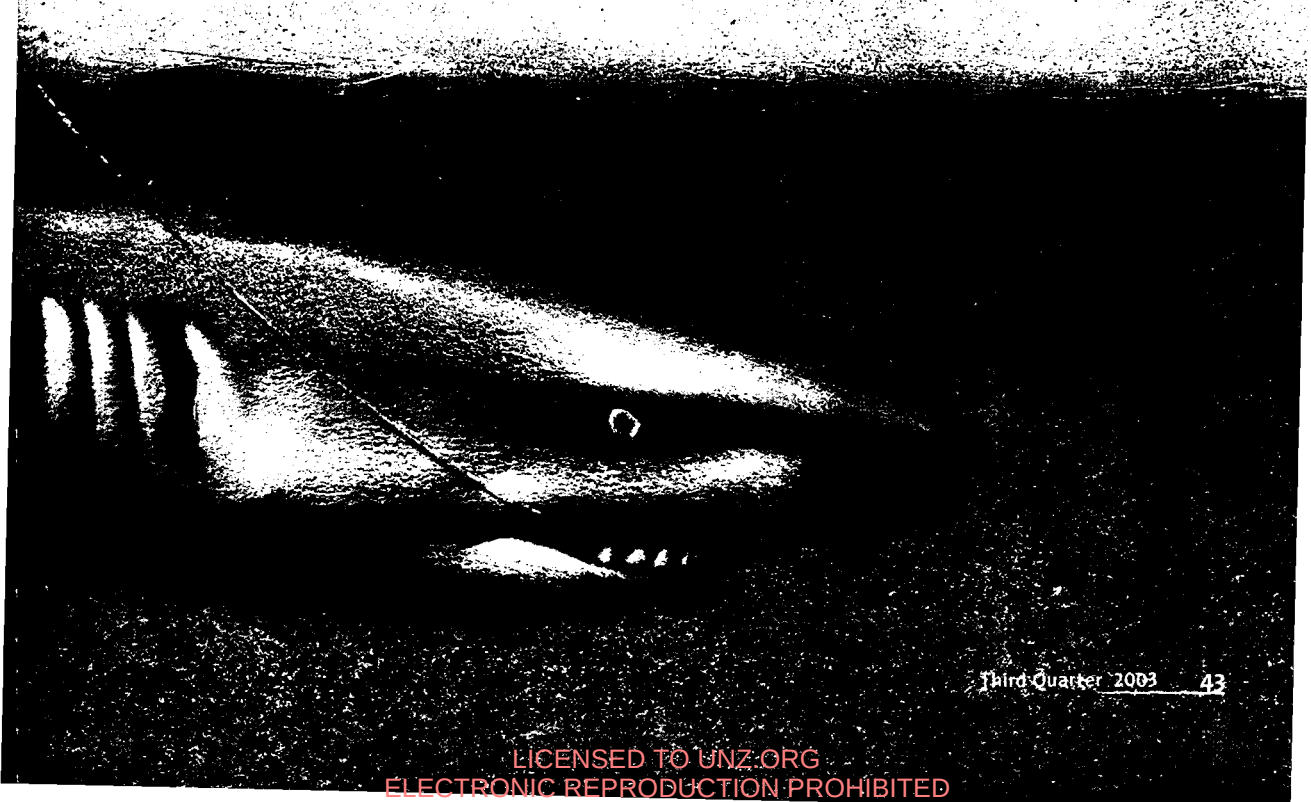
help classes full of MBAs see that there is more to life than money, power, fame and self-interest." And in response to the more recent wave of corporate scandals, Provost Thomas Lindsay of the University of Dallas noted what he believed to be a source of the problem: "business school education is devoted overwhelmingly to technical training" and not to the development of students' "moral capacities." As a consequence, his university had established a "business degree program that marries technical courses with the liberal arts," in the process integrating "ethical exercises" throughout the students' business courses.

Others have hopped on the bandwagon. The Association to Advance Collegiate Schools of Business now requires its 432 member schools to make ethics a top priority. And the association is pondering the step of asking members to develop formal codes of ethical conduct for students, professors and administrators. In the view of some 120 professors from a number of business schools, this falls far short of what is needed. They recently signed a petition demanding that students be required to take a stand-alone ethics course during their two-year MBA programs. And some business school students agree. In a survey conducted last year by the Aspen Institute, one-fifth of the MBA candidates from top schools said they were disappointed by the absence of ethics training in their MBA programs (*Browning*).

Their logic is straightforward, though hardly psychologically sophisticated: if executives have had ethical lapses (which few dispute), then teach budding executives the difference between right and wrong. We believe that such MBA-level instruction would surely do little harm. However, there are good reasons for believing it wouldn't do much good, either.

DÉJÀ VU ALL OVER AGAIN?

One reason not to expect much is that many of today's executives and managers were themselves exposed to ethics education in business school. Indeed, for more than two decades the Association to Advance Collegiate Schools of Business has required accredited undergraduate and MBA programs to



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offer courses in business ethics or to integrate ethical considerations into existing ones. And while the ranks of corporate executives who have graduated from prestigious schools that met the requirement is impressive, some still managed to stray from the straight and narrow path.

Granted, some MBA programs might not be doing what they claim to be doing (an issue of ethics in itself). But is there any reason to believe that more of the same would work better? When schools are required to teach ethics even though they don't see the need, should we expect much more than window dressing?

MAYBE IT'S TOO LATE

Proponents of additional ethics training for MBA candidates should understand that schools face an uphill battle in changing the behavior of their students, who typically have already had considerable experience in the business world. Granted, some may ace any ethics exam placed before them. But there is a big difference between scoring well and doing well when confronted by high-stakes ethical problems in the real world.

The material that MBA programs in the United States must shape is not always promising. The Josephson Institute of Ethics in Marina del Ray, Calif., surveyed more than 12,000 high school students in 2002 (*Josephson Institute*). Some 74 percent of them admitted to cheating at least once (compared with 61 percent in 1992), 38 percent had stolen something (up from 33 percent in 1992) and 92 percent had lied to a parent. Moreover, 43 percent of the respondents strongly agreed with the statement, "I would be willing to lie if it would help me get a good job."

Nevertheless, three-quarters of the students prided themselves on personal virtue, claiming, "when it comes to doing what is right, I am better than most people I know." A similarly large percentage said that their parents wanted them to do the right thing, and virtually all respondents agreed that it was important to them to be trusted by others. This means that a substantial majority admitted to having cheated, stolen or lied in spite of recognizing the difference between right and wrong, and in spite of claiming to understand the value of personal integrity.

ETHICS 101 OR CATECHISM 101?

While there may be any number of good ethics courses in MBA programs, no one should be deluded into believing that most – especially those taught only in response to a mandate – measure up. "Ethics" is one of those delightfully ambiguous words whose definition is perpetually in dispute.

For some, teaching "ethics" means nothing more than indoctrination in what is religiously or politically correct, while for others it amounts to laying down the law, however subjective. In his *Newsweek* column, Etzioni chastised his Harvard students for believing that advertising had a social value, never not-

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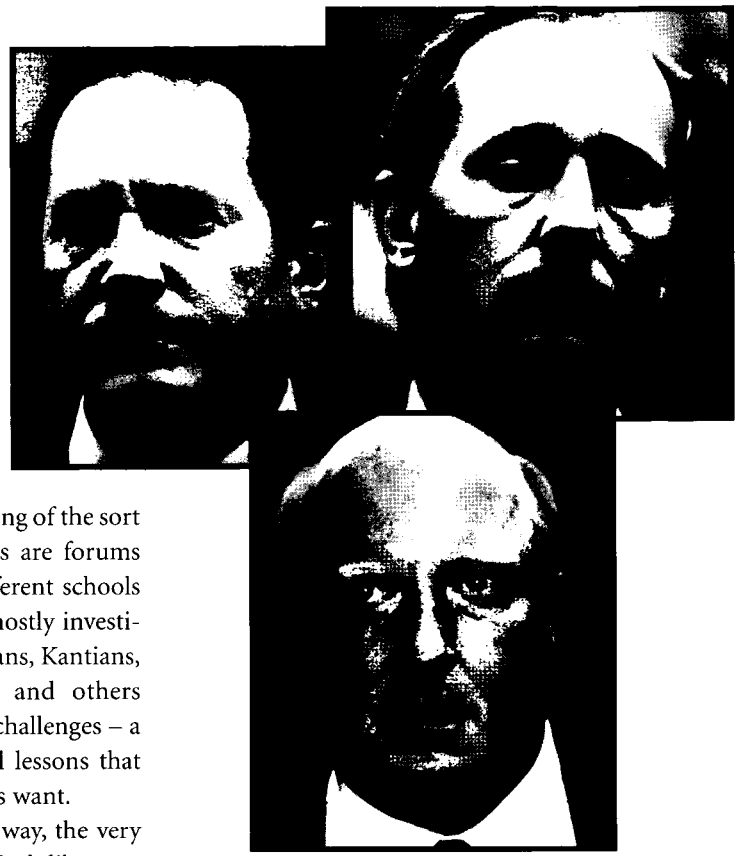
ing counterarguments by such notable social philosophers as F.A. Hayek. Do we really want professors to be evangelists for their own ethical viewpoints? If not theirs, whose? Imagine the business ethics that would have been taught in all-white universities in the 1940s and 1950s.



In fact, in the cautious world of higher education, nothing of the sort happens. At best, ethics courses are forums for a guided exploration of different schools of thought. So, typically, they mostly investigate what utilitarians, Aristotelians, Kantians, pragmatists, egoists, altruists and others would do in the face of ethical challenges – a far cry from the Sunday school lessons that critics of contemporary business want.

To put the problem another way, the very teaching of ethics creates an ethical dilemma. After all, most schools of higher learning say their goal is to promote inquiry, not to inculcate somebody's settled doctrine.

ETHICS TEACHING AS DIVERSION

Ethics courses come at a cost, not so much in dollars and cents but in terms of other courses that could have been taken instead. Moreover, these other courses – for example, accounting – might do more than ethics instruction to keep firms on the straight and narrow. An ethics class might explore how various schools of thought see the difference between right and wrong, but other business courses can improve their ability to detect dishonest behavior.

Sherron Watkins, the vice president at Enron who alerted the company's chairman to the company's apparent misdeeds, recently gave a talk at the business school of the University of California (Irvine). One student asked her how she discovered that her company was a financial house of cards. She didn't respond with praise for her ethics training. Rather, she explained how her accounting training had come into play, saying something to this effect: "I noticed in Enron's financial documents that one of the company's external partnerships had $700 million of Enron assets on its books, all backed by Enron stock. I thought to myself, 'If these assets are good enough to be backed by the company's stock, why aren't they good enough to be on Enron's books, backed directly by the company?' "

Students who forgo an accounting course to take an ethics course could easily miss the distinction; something had to be wrong with the evaluation of those assets. Watkins quickly discovered that the partnership was an

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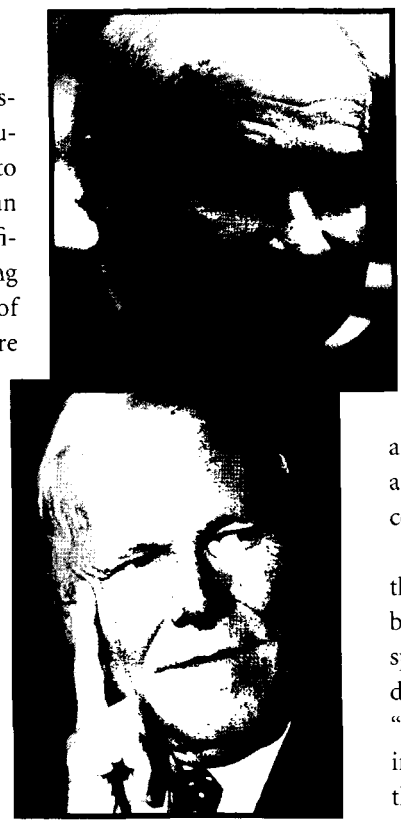
accounting sham, designed to get both failing and underperforming assets and the accompanying debt off the company's books.

THE ETHICS OF ETHICS COURSES



Then there is the ethical question of whether business students should be required to spend money and time on an ethics course. This is significant, given the widely varying economic circumstances of MBA candidates. Some are pursuing degrees full time, while others must combine work with school. By the same token, business students are a mix with radically different experience levels and educational, religious and cultural backgrounds. In an era in which diversity is celebrated, instructing students on matters of right and wrong would seem to undercut the goal of respecting differences.

It is rather odd, in any case, that ethics teachers and texts tend to zero in on business as somehow especially prone to unethical behavior, even though unethical behavior can plague any profession – not least, university teaching.

DOES ANYBODY REALLY LISTEN?

The proponents of ethics courses seem convinced that ethics courses make people behave more ethically. But research on the issue is inconclusive.

A 1988 study compared the moral judgments of nearly 2,300 business managers and other professionals with those of some 200 college students who were taking a business ethics class at the time (*Wood, et al*). Respondents were asked to circle a number on a scale of one ("never acceptable") to seven ("always acceptable") for 16 ethical "vignettes." Here are two examples:

- An executive earning $50,000 a year padded his expense account by about $1,500 a year.
- Because of pressure from his brokerage firm, a stockbroker recommended a type of bond that he did not consider a good investment.

The researchers concluded that 8 to 10 percent of the business and professional respondents showed "no moral dimensions." They added: "Nothing legal, moral or interpersonal will stand in their way of pursuing their own interests to the limit. Neither motives nor consequences mattered." About the same percentage of undergraduates in a business ethics class held much the same values.

This study also concluded that in seven of the 16 vignettes, the ethics students were more inclined than the business executives to engage in "questionable activity," while business people took the dubious prize in just one. For example, three-quarters of the business people said that expense account padding was "never acceptable," while only one-fourth of the ethics students marked "never acceptable." (In the remaining eight

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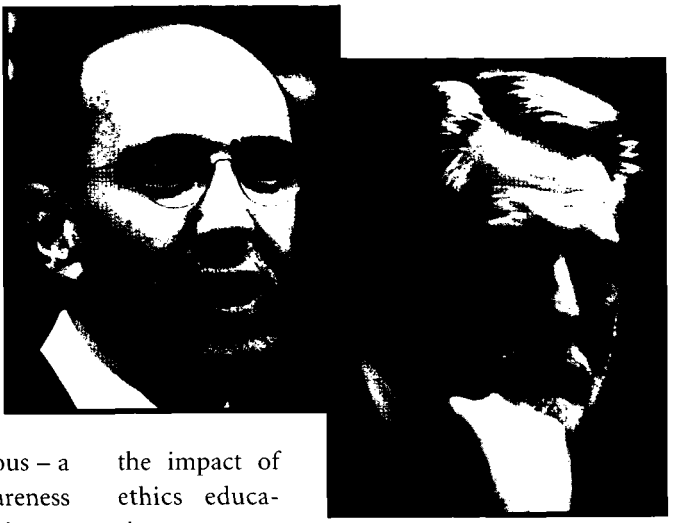
situations, there were no significant statistical differences between the two groups.)

It is unclear whether ethics courses affect outcomes. One study found a significant improvement for management students, but not for accounting students, on issues of "social responsibility" (*Arlow and Ulrich, 1980*).



Another study suspected that the measured improvement was spurious – a function of the students' greater awareness after the ethics course of what the questioners wanted to hear (*Wynd and Mager*). To account for this potential "premeasurement bias," they tested 345 students at the start of their ethics classes and then gave the test to a different set of 205 students at the end of their ethics courses.

These researchers asked students to indicate the extent of their approval or disapproval on a scale of one to five on 17 conditions – for example, "executives conspire to fix prices for electrical equipment" and "auditor overlooks bribe." The study concluded that the ethics classes had "no significant impact on student attitudes toward ethical decision situations." The researchers attributed the absence of impact to the fact that "basic values" are set early in life and are subject to change only by "significant emotional events." A single course in ethics, they suggested, is "apparently not enough of an emotional event to change students' attitudes."

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To be sure, research results in this field are sufficiently ambiguous to allow for a variety of conclusions. In a 1992 review of the major assessments of the impact of ethics education, seven out of 10 studies reported a positive impact, while only two studies showed no impact and the remaining study showed mixed results (*Glenn*). Over the course of four years, this researcher presented 460 undergraduate and MBA candidates taking courses in "business and society" with 53 ethics situations at the start and at the end of the course. These situations required the students to make what the researcher considered to be "ethical judgments." An unstated number of other students, enrolled in other courses, served as a control group.

Students in the treatment group improved their ethical scores over their course work, but so did the students in the control group. In fully 75 percent of the situations, there was no statistically significant difference in improvement between the two groups. This implies that in only a quarter of the situations did the treatment group improve more than the control.

Another study of 261 students in a business and society course, which emphasized "ethical components of managerial decision-making,"

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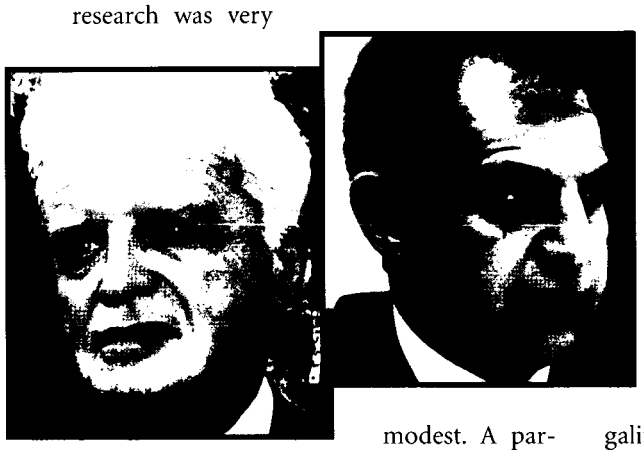
showed a significant improvement in the "moral reasoning" between the start and end of the class (*Boyd*). However, the difference in outcome between the ethics students and a control group taking a course in operations research was very modest. A parallel study of students in an organizational behavior course with some coverage of ethics by the same researcher actually showed a decline in test scores.



YOU SAY POTAYTO, I SAY POTAHTO

Note, moreover, that the tests showing positive results have often been designed with the content of the course – not an independent framework of ethical behavior – in mind. Did a course improve the ethical judgments of the students on the many ethical matters not covered by the course?

We simply don't know.

What we do know is that the situations presented to the students on the surveys had Delphic ambiguity. For example, here are four of the situations in which the treatment group's improvement was greater than the control group's:

1. "Whatever is good business is good ethics."
2. "Competition forces businessmen to resort to shady but necessary practices."
3. "In a merger scenario, I would not use inside information to make profit from rising stocks."
4. "A separate ethics course should be included in my degree program."

Now, Statement 1 is ambiguous because it depends on unspecified definitions of "good business" and "good ethics," and the students in the control group may have suffered more from not knowing the researcher's definition of "good." With regard to Statement 2, economists have long argued competition itself forces business people to shy away from "shady" practices.

Or consider Statement 3. Using insider information for personal gain is illegal. The students in the course may have conflated the fact of its illegality with the (debatable) idea that it is unethical. Statement 4 is an invitation to students completing the course to conclude that they didn't waste their time.

Note, too, that the research doesn't have much to say about the sticking power of learned ethical behavior. One set of researchers who reported positive findings on the impact of an ethics course among 120 students at the time they took the class tracked down the students four years later and retested them (*Arlow and Ulrich, 1985*). They found no difference between the ethical reasoning of those students and that of a control group never exposed to ethics training.

Most subjects learned in school require some maintenance – that is, time and resources in the review of key concepts. And students forced to take a course may see no personal gain from keeping up.

Indeed, the problem of getting people to act ethically (with or without training) is much like the problem of getting them to pay their taxes voluntarily: many people won't do it without some direct incentive. And even

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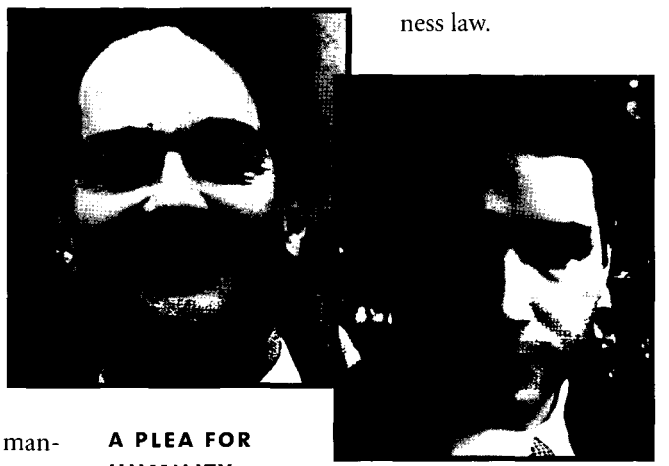
people who understand that ethical behavior is good for the group may decide to take a free ride on the good behavior of others.

Furthermore, the field of business has a special problem with ethics. Government regulates many business activities with ethical objectives in mind. So professionals are not expected to do the right thing because they think it's right, but because they are legally required to do so.

Consider minimum wage laws, which pretty much remove from the sphere of business the concern about whether employees are being paid well enough. The same could be said for other labor issues such as discrimination. Indeed, all too often, ethics courses become mired in matters of what government rules are mandated, instead of focusing on what is the right way for people to conduct themselves.

Indeed, so many of the challenges presented to students in appraisal of their moral reasoning evaluate only their understanding of the law. For example, researchers at Stetson University wrote that they intended to measure business students' propensity to engage in illegal and unethical practices (*Duizand and McCann*). However, in constructing 11 scenarios for a before-and-after survey, they chose only matters that constituted illegal acts, including several violations of the Internal Revenue Code and other violations of the country's tort, copyright, fraud, securities, immigration, bribery and antitrust laws. It's no wonder the business students outperformed the comparison group; they knew more about business law.



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A PLEA FOR HUMILITY

You may be tempted to conclude that we oppose any and all training in business ethics. Not so. What we do oppose is the simplistic view that mandated ethics courses will improve business conduct.

Perhaps business schools can contribute more to the ethical maturation of leaders-to-be. Perhaps not. But woe unto those who believe there is a magic bullet for preventing the sorts of lapses in business ethics that have surfaced in the past few years. M

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My Weekend with Nick and Adam

Tax policy and other willful misunderstandings

by Leonard Burman and Joel Slemrod

The following is an imaginary debate between partisans in the modern tax policy wars. The goal is to try to tease out economists' honest differences and maybe find some common ground. Although we've heard real people make every one of the arguments expressed here, our characters are fictional. — LB and JS

I'm an economist and a tax expert, but you'll never see me on the CBS Evening News. For I am a two-handed economist ("on the one hand … on the other hand … "), the kind that Harry Truman hated and TV news show bookers avoid like SARS. I see two sides of almost every policy issue. In short, I am not constituted to enlighten in 30 seconds or less.

But I'm the exception; one-handed economists abound. I (naturally) have mixed feelings about these folks. As an economist and a teacher, I am always thrilled to see economics explained to the innocent. Yet, those insights seem to take the true believers places even Captain Kirk has never been before.

Thus, it is odd that I ended up spending a January weekend alone

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with two one-handers. Nick, the son of Russian immigrants, is almost religiously committed to free markets and has a visceral aversion to government. Adam, a native of Brooklyn and the son of labor organizers, believes government is there to help the oppressed. Ironically, these guys have been friends since grad school. The fact they've never changed each other's mind on a single issue hasn't dampened their ardor for debate.

Let me explain how this weekend came about. I teach at a small college. Every January, I join other professional colleagues at the economists' annual conference, which this year was in Pittsburgh. I ran into Nick and Adam at the airport. But they were fighting tooth and nail, and I didn't want to interrupt their fun.

Two hours into the flight, the pilot announced that a nasty storm had made Pittsburgh an impossible dream. We ended up in Nashville, to find the airport packed and no room at the inn. As I was denouncing my fate, Adam waved me over. Seems he had arranged to borrow his cousin's nearby cabin , and Nick had scrounged the last rental car available.

The little car from Seoul or Jakarta or someplace was too small for the three of us, and the roads were slick. But even more disconcerting, my companions were soon at each other's throats over the latest tax bill from the Bush administration.

"You people are shameless," accused Adam. "Our country is facing a fiscal emergency, and your solution is to borrow more money to pay for tax cuts for the rich! How can you look your children in the face?"

"No problem," Nick sneered. "You liberals are interested in fiscal responsibility only when it comes to tax cuts. If the President had proposed going into debt to finance national health insurance, subsidies for child care or more college scholarships, you would be leading the parade. And that would leave our kids in the poorhouse."

"Whoa!" I protested. "You guys sound like you're not even from the same species, never mind the same profession. If economics is a science, how can you two reach opposite conclusions about almost everything?"

Serious economists across the ideological spectrum really do agree about many of the basics. For example, we agree that tax policy plays a crucial role in economic policy and in government operations more generally.

Or do we?

"The impact on incentives is always overrated by right wingers like Nick," Adam explained. "As Charlie Schultze, Jimmy Carter's chief economic adviser, likes to say, 'There's nothing wrong with supply-side economics that dividing by 10 wouldn't cure.' "

"Come on! There are two centuries of evidence that people respond to incentives," parried Nick.

I asked my traveling companions if they agreed that, in raising revenue, it would be best to level the playing field – that is, not penalize one activity more than another or favor one sector over another. That is, to let the market decide.

"Ah, the market!" Nick rhapsodized. "The invisible hand will always do better than the bureaucratic, arm of government."

"Sure, markets are amazing under certain conditions," Adam conceded. "But those conditions are violated again and again in the real

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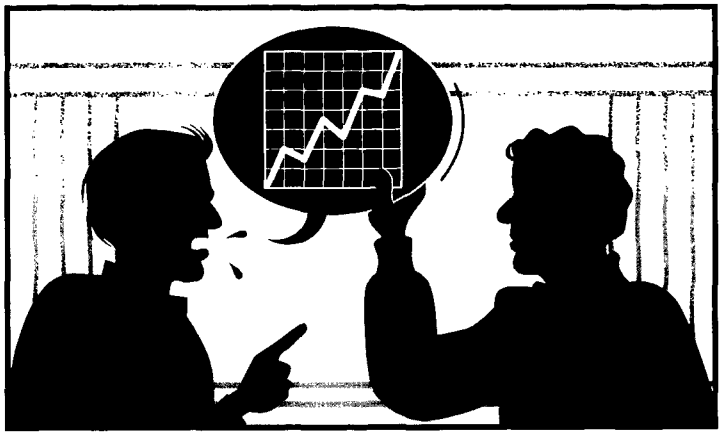


world. Yes, a market can efficiently allocate, say, rights to pollute – but only after government establishes those rights and creates a way to enforce them. Left to its own devices, the free market would allow cowboy capitalists to make the earth uninhabitable. Nor can the market guarantee that hard-working people will be able to afford basic needs – decent health care, housing, retirement security."

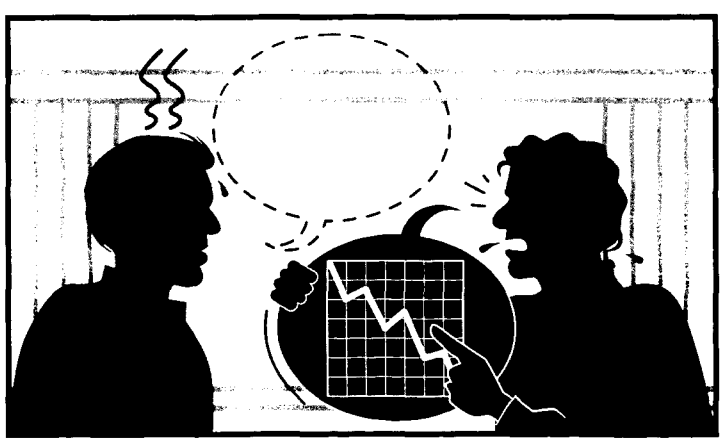
We were lost (literally), and I was starting to worry that I would be found dead – wedged into a tiny rental car with two guys who would no doubt be frozen for posterity in mid-epithet. I resolved that, if we survived the night, I was going to find some common ground for my old classmates.

Miraculously, we found our bearings – and the cabin. More miraculously, the cabin had central heating and food to last the weekend. By morning, it was clear that there would be no way back up the driveway, let alone to the economists' convention.

So I set about playing mediator for my companions. Over breakfast, I began, "Do you agree there are three criteria for judging tax policy: equity, efficiency and simplicity?"

Adam nodded. "The burden of taxes should be shared equitably according to society's standards. Americans want this burden to be higher for those of greater means and want those with more income to pay a larger percentage in tax than those with less."

"There are three goals, Adam – not one," Nick rejoined. "You liberals don't give a damn about efficiency or simplicity. You are willing to make everyone worse off just so the most productive people don't get to keep much more than the slackers. And your 'refundable'



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tax credits – spending programs in drag – complicate taxes horrendously. It's not just that you want the tax system to be progressive; every single provision must be targeted to people with lower incomes! That's ideology, not principle."

Adam bristled. "Lots of differences in earning capacity have to do with luck rather than skill or hard work. If you didn't know you were going to be one of the lucky few, you would surely want to live in a society with a safety net. And don't tar me as the ideologue around here! You claim high tax rates discourage work and saving, but your motive could just as well be pure greed."

"I prefer to think of it as the laudable desire to provide for one's family," Nick replied. "I do admit, though, that I am not as troubled as you are by inequality, as long as the game is not rigged – and I don't think government should be in the business of second-guessing outcomes."

Adam responded that Nick really opposed all taxes; indeed, all government.

"Not true!" laughed Nick. "I'm happy that the government operates the military, courts, federal prisons and maybe interstate highways. We could probably pay for all that with a flat 5 percent income tax."

"Now we're getting to the heart of the matter," Adam exhorted. "Folks like you above all want smaller government. But you don't believe that you can achieve that goal directly, so you seek to 'starve the beast,' as Reagan's budget director, David Stockman, put it."

"Bingo!" Nick said as he jumped up from his chair. "If we hadn't cut taxes in the last two years, you Democrats would have piddled the surplus away on spotted owl reserves."

I wondered out loud whether the argument wasn't really as much about the appropriate size of government as it was about how we should pay for it.

"That's part of it," Adam concurred. "The Republicans are trying to starve government so that we will have to slash funding for welfare, education, Social Security and Medicare."

"Maybe," responded Nick, "but we could get a lot of the savings by eliminating waste, fraud and abuse."

Adam sighed theatrically. "You're not going to eliminate these massive deficits by trimming fat. You're going to have to cut deep into the muscle. Your real political problem is that most people like the programs conservatives want to slash."

"People like free services and monthly checks in the mail," Nick responded. "But people don't realize the true cost – not just in terms of higher taxes, but in lower productivity. And slower growth will hurt our kids a lot more than deficits."

"There's no compelling evidence that taxes at the level we pay – just about the lowest in the industrialized world – have much effect on work, savings or investment," Adam said. "Besides, why assume away the positive role that government can play in fostering economic growth? Think of all the government dollars shelled out to protect property rights, provide infrastructure and support education."

I found my chance to intercede. "Why is it that so many liberals believe the effect of taxes on incentives is small, while their conservative counterparts believe that taxes create huge distortions? Since this is an empirical question, you'd expect the conclusions to be independent of one's politics."

"Not necessarily," Nick responded. "Some conservatives are skeptical about government because we view the costs of paying for it as very high."

"Do any Republicans believe that taxes don't affect behavior much?" I asked. "Do any Democrats believe that taxes are costly?"

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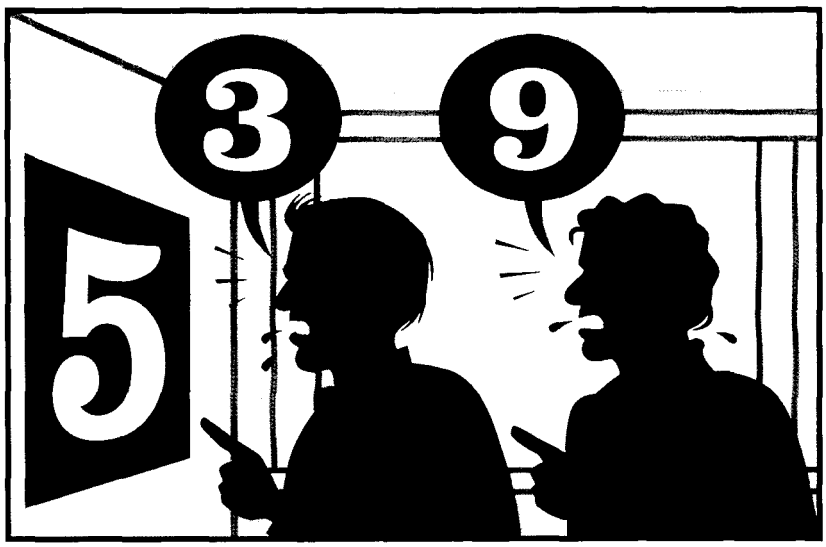

Nick and Adam agreed there must be some, but couldn't name any. In science, there are truths. In economics, at least as practiced in Washington, there are advocates who claim to be custodians of ideologically convenient truth.

I asked again if we could agree that the debate about taxes is largely about the size of government. My fellow campers agreed. Then I asked if starving the beast works.

"Absolutely," Nick was quick to reply. "Larger deficits lead to trimmer government."

"Not always," Adam said just as quickly in rejoinder. "In the 1980s, Reagan slashed taxes, but never reined in spending."

"That was the fault of the Democratic Congress!" Nick countered.

"But Reagan never came close to proposing a balanced budget. So we got monster deficits and a huge run-up in debt. The process was reversed in the 1990s, when two tax increases were paired with spending restraint. That, in combination with the strong economy, vanquished the Reagan deficits," Adam said.

"I'm surprised there's no patriotic music playing in the background," sneered Nick. "The fiscal discipline of the 1990s was a direct consequence of the deficits of the 1980s. Congress passed Gramm-Rudman-Hollings and the Budget Enforcement Act – both signed by Republican presidents – which ultimately got spending under control. The Stockman Effect worked."

"If deficits don't constrain spending," I asked Adam, "why do you always bring up Social Security, Medicare and homeland security as programs that would be underfunded during times of deficit?"

"Well, if deficits got big enough – "

"I get it now," I volunteered. "Republicans favor tax cuts because they think cuts constrain spending. Democrats oppose them because they fear that the Republicans are right."

We helped Nick make lunch with treasures unearthed in our host's pantry – fettuccine tossed with sun-dried tomatoes, porcini mushrooms and estate-bottled olive oil. "Not all Republicans," I allowed, "rely on barefoot wives for food."

Alas, my feeble attempt at humor quickly segued to a heated discussion about the welfare state and the cycle of dependency –

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whether the 1996 welfare reforms were a success or a failure, and whether the Democrats or Republicans deserved the credit (if it was, indeed, a success). I washed dishes and tried to visualize world peace. It didn't work.

I asked Nick if he was troubled about saddling future generations with debt. Running deficits is a way to put off burdens without specifying who will bear them, I noted. And if low taxes and high deficits unleash greater economic activity now, won't the higher taxes needed to cover the interest payments squash economic activity in the future?

"We'll take that chance," said Nick, while sipping espresso. "When the time comes, we'll be arguing for less government spending, rather than higher income taxes. And for privatizing Social Security and Medicare rather than shoring it up with higher payroll taxes."

I crept away for a nap. When I woke up, Adam and Nick were having at it about the "jobs and growth" tax cuts just passed by Congress. Adam was gleefully rattling off statistics about the numbers of jobs lost since President Bush took office.

"Can we talk about what should be done now?" I asked. "Are tax cuts the right policy?"

Nick swung hard at this soft pitch. "Yes, a thousand times, yes. For one thing, tax cuts put more money in people's hands, and when they have more, they spend more. That raises demand, so companies hire more workers, and so forth. For another, lower marginal tax rates give people more incentive to seek the jobs that are out there, and give businesses more incentive to invest."

"Everyone who ever passed Economics 101 knows that government spending is probably more effective at stimulating the economy than tax cuts," interjected Adam.

"But only tax cuts can reduce marginal tax rates," said Nick.

"Can I interject here?" I interjected. "I've taught Economics 101 for many years, and even been around the block a few times with Econ 201. Most economists think monetary policy works better for short-term stabilization than either tax cuts or spending, because it can be better timed."

"You're right, as far as it goes," said Adam, "but voters expect more than easier credit."

"I asked an economics question, and you gave me a political answer. Maybe it's time to fess up that we really don't have a clue about how to micromanage fiscal policy.

"And why are you suddenly so quiet, Nick? How can a supporter of limited government be for government intervention to prop up the economy? Are you all Keynesians now?"

"I guess we are," admitted Nick, "but mostly because it serves our larger purpose of cutting taxes and, ultimately, downsizing government. You may have noticed that the Bush tax cut proposal of 2001 was first made in December 1999, well before anyone smelled recession in the air. Once the economy began to slip, we changed the rationale without changing the proposal. Some wag called it the 'tax cut for all reasons.'"

"Hey, don't forget that it was the Democrats who insisted that the tax cut begin with those tax rebate checks, targeted at middle-income families," Adam bragged. "Giving money to people who are short on cash is much more effective stimulus than tax breaks for zillionaires. Lower-income folks are more likely to spend their tax rebates than the corporate CEOs and coupon clippers."

"Actually," said Nick, "evidence from the 2001 tax rebate shows no such thing. Low-income families were no more likely to spend the rebates than other families. Truth is, Democrats know that, once enacted, tax 'expenditures' are difficult to reverse. Tax cuts targeted toward low-income people serve

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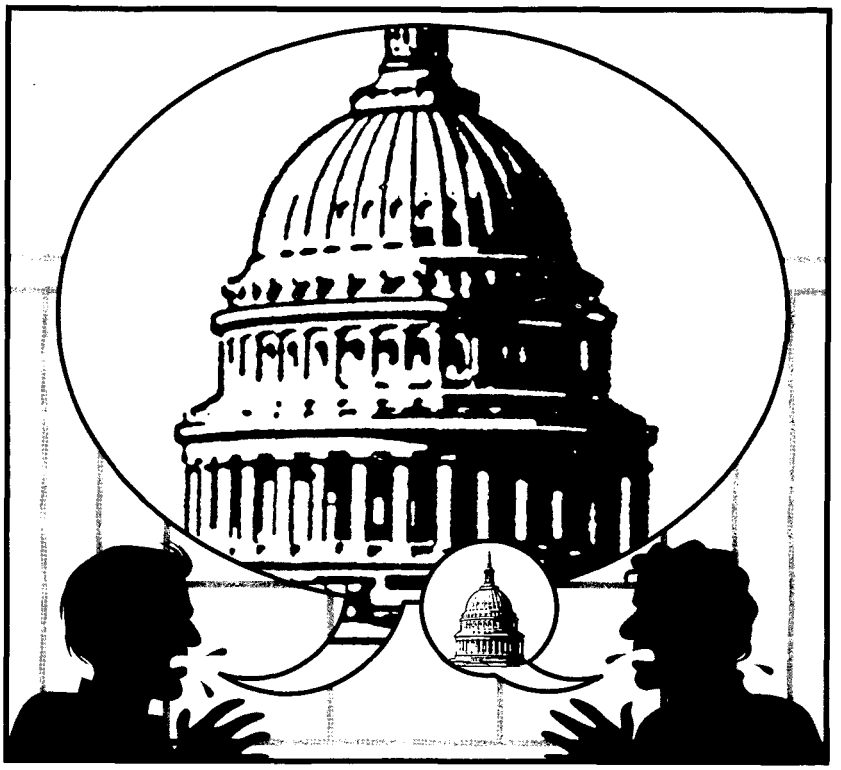

their core constituency."

"You make it sound like helping poor people during hard times is somehow sinister," complained Adam. "We're proud that the tax rebate was not just abstract macroeconomic 'stimulus.' It helped struggling families to pay their bills. Single mothers clearly needed the boost more than did the BMW crowd – though the latter drove away with the loot."

"Actually, the same study suggested that most people didn't spend their rebate checks at all, but saved the money or paid down debts," I interjected. "So the tax cut didn't provide much stimulus at all."

I avoided the line of fire by making dinner. Later, I fell asleep and dreamed of moderates driving snowplows. The next morning the weather had much improved and I was able to book a flight to Denver. Adam tussled with the airline about the $100 rebooking fee, complaining that this never happened before airlines were deregulated (in the 1970s). Nick responded that Adam's ticket would cost three times as much if airlines were still under the government's thumb. I tuned out the entirely predictable argument that followed.

On the way back to the airport, I made one last attempt to find common ground. "Surely we can agree that everything possible should be done to make tax-paying simple and straightforward."

"Actually, I'm not sure about that," said Nick. "It may seem hypocritical to rail against inefficient government, and then turn around and oppose the IRS's efforts to become more efficient. But I have to admit I want taxpayers to feel the pain of taxes – I don't want the burden hidden. That's why conservatives opposed income tax withholding when it was first introduced during World War II and why our first flat-tax proposals would have eliminated employer withholding. I guess I'm willing to accept an inefficient tax collector if the end result is less government."

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MISUNDERSTANDINGS

"I'm glad that you have mixed feelings about that," I said, "because I find it very troubling to think of sabotaging the tax system to achieve other government objectives. An archconservative, one closely aligned with the Bush administration, told me that he favored the pointlessly complex alternative minimum tax because it made people hate the income tax.

"Let's try another tack," I suggested. "Maybe because of the return of deficits, and the pressure to support our troops under fire, tax evasion is back in the news. What do you think about the 'tax gap,' which the IRS estimates to be about $200 billion per year? I'd think you'd both be able to support a crackdown on tax cheats."

Adam agreed. "Tax evaders are stealing from honest taxpayers and our children. Hell, Nick has always supported the death penalty for drug dealers and murderers, two groups apparently immune from its deterrent effect. But if we fried a couple of tax cheats, that would create a very cost-effective deterrent."

"You're not serious," I said, taking the bait.

"No," he answered, "but I do think we should come down hard on people and businesses who cheat on their taxes."

Nick agreed, but with reservations. "Let's not forget that the main reason for cheating is high tax rates."

"Why is it that in your eyes draft evasion is tantamount to treason, but tax evasion is practically the duty of every American?" rejoined Adam. "OK, I take that back, but it infuriates me that the IRS seems to spend as much of its energy tracking down abuses of the earned income tax credit for the working poor as it does to shut down tax haven scams worth billions more. Indeed, the IRS is planning to spend millions making some low-income people prove in advance that they are eligible for this credit – something no other group must do."

"The EITC is welfare paid out through the tax system, mostly to people who owe no income taxes," Nick complained. "If we can't move welfare out of the tax code, at least we can cut down on its rampant abuse."

"The EITC is basically a work incentive that is the antithesis of welfare," Adam responded. "It's a Republican idea – Milton Friedman suggested it 30 years ago, before Republicans got mean."

An argument about the Republican agenda and compassionate conservatism ensued. I was relieved to arrive at the airport and say farewell to my argumentative friends.

On the flight home, I tried to make sense out of what I had heard and learned about our profession. Here it is, unvarnished; I hope it doesn't sound two-handed:

Economists agree that taxes should be fair, simple and promote efficiency, but we can't agree about how to balance these sometimes-conflicting objectives. Deep disagreements about how taxes affect economic behavior, uninformed by the empirical evidence, are the rule.

To complicate the debate further, conservatives and liberals usually seek enlightenment in the evidence most consistent with their respective positions. Conservatives argue that taxes exact huge costs in terms of lost productivity; liberals deny it. The rest of us admit our ignorance.

In large part, the tax debate is not about who should pay or about how to kick start the economy, but about the size and scope of government. No economist believes that running large and growing deficits is sustainable policy. But conservatives are willing to run deficits for a while if doing so will starve the metaphoric beast. Liberals say that starvation doesn't work, but they fear that it will.

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A Nobel Round Table

A highlight of the Milken Institute's annual Global Conference (held in Los Angeles March 31–April 2) is the panel of Nobel laureates in economics, moderated by Michael Milken. And this year's round table was no exception. The panelists: Ken Arrow (Stanford University), Gary Becker (University of Chicago) and Myron Scholes (Oak Hill Platinum Partners. Herewith, their conversation, edited for clarity and space. – *Peter Passell*

MICHAEL MILKEN: Let's begin with a look at the world's second- and third-largest economies [Japan and Germany]. It has been more than a decade now since Japan started the process of rebuilding its financial system. Yet we have seen declines of more than 80 percent in equity prices and 80 percent in real estate. Today, more than half of all personal assets are held in cash – $12 trillion yielding less than 1.5 percent.

Why has it taken so long to get Japan going? And can we do something to get it going by the end of this hour?

GARY BECKER: There is a misperception about what happened in Japan in the last decade. Japan has not suffered a serious erosion in income. What it has had is stagnation: population stagnation, income stagnation.

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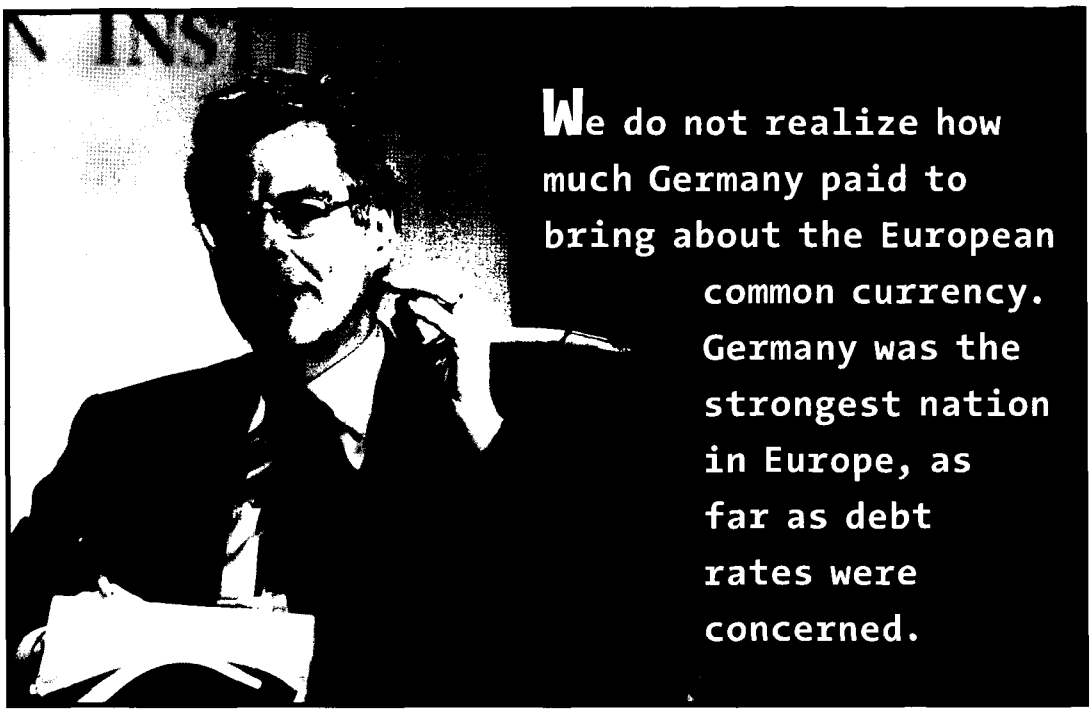
We do not realize how much Germany paid to bring about the European common currency. Germany was the strongest nation in Europe, as far as debt rates were concerned.

Japan is still a very rich country with a lot of real assets: strong human capital, some very good international companies capable of fighting for a share of any market. But it can't face up to the need to get rid of zombie firms. Indeed, most banks, which continue to throw money at failed borrowers, would probably show a negative net worth if they ever did a true accounting.

Japan's problems are thus twofold. First, it has been reluctant to clean up the financial system. The United States, by contrast, moved much more quickly with a smaller problem in the 1980s: the savings and loan crisis.

Second, Japan remains a closed, overregulated market. It has never been a major importer of foreign capital. And it is hostile to immigration, even though it has a rapidly aging workforce.

MYRON SCHOLES: Let me amplify Gary's thoughts. When a country has a budget deficit equal to 7 percent of GDP and it is growing by less than 1 percent a year, when it has a 120 percent debt-to-GDP ratio, something has to give.

What is allowing the government to finance this tremendous deficit is its trade surplus with the rest of the world, and the willingness of its citizens to hold huge quantities of government bonds.

When the banking system failed in the early 1990s, corporations failed. And when corporations failed, the banking system failed. Therefore, society ended up owning both the corporations and the banks.

But instead of saying, "OK, we will have to recapitalize and move on," the Japanese instituted a system built on debt forbearance. Instead of recapitalizing, they swept the problem under the rug, hoping that something would create the value to bail out the debtors. As a result, the bankers became very afraid of lending money to anyone other than Toyota (which did not need to borrow). The lending

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infrastructure has, in effect, disappeared. A lot of financial technology was destroyed. Basically, middle-market entities have been starved for lack of loans.

MILKEN: We had a situation in the United States in the 1980s where the banks really did not provide capital. But the economy was not dependent on the banking system because it could count on the public markets. And so a company like BankAmerica, which was the largest bank in the world at the beginning of the '80s, could shrink in real terms by 50 percent without slowing down our economy.

KEN ARROW: We haven't factored in the impact of Japan's very high savings rate. Many would argue that savings is part of the Japanese problem – which is an odd thing when we think of savings as a provision for the future. But maybe some elements of Keynesianism are not dead; the high savings rate has driven down rates of return to a level that some might interpret as a "liquidity trap."

MILKEN: If you want to save a million dollars at a rate of return of zero, you would have to save $25,000 a year for 40 years. In the 1990s, when anyone could get 12 percent in the United States, you could do it in a fifth that time.

SCHOLES: You have to be careful here, because in a deflationary environment such as Japan, the real rate is much higher. If prices are falling, even a zero nominal rate of interest means you're making something.

MILKEN: So by investing at a zero interest rate, you're actually getting a positive rate of return today?

BECKER: In real terms, the Japanese are probably getting 2 or 3 percent on their money.

I doubt that the high savings rate in Japan is a problem. Ironically, not long ago most U.S. economists were lamenting the fact that America had a low savings rate – which they said explained why Japan was eating our lunch. I think people exaggerated the strengths of Japan and the weaknesses of the U.S. at that time. And I think the situation is now reversed. When things turn around, high savings will become an asset.

MILKEN: So if we could get some of the regulatory and financial technology in place, Japan would have excellent opportunities for growth – for building small and medium business, creating jobs, etcetera.

SCHOLES: One last point: they have to stop the big public works programs, which do nothing but waste society's resources and increase government debt.

MILKEN: So they're burning money?

SCHOLES: They have a lot of it, as Gary said. But it is not productively used.

BECKER: Their deficit spending was initially meant as Keynesian pump priming. They thought they could spend their way out of the recession. If you go back to 1992, Japan was not a high debt/GDP country. The current mess is all a result of the misguided policies in the '90s.

MILKEN: So they have spent trillions of dollars on the problem, and still not solved it.

SCHOLES: At this rate of debt growth, Japan's national debt will equal 220 percent of GDP in five years!

MILKEN: Let's turn to the third-largest economy in the world, Germany, which must deal with the issue of integrating East Germany. How do you see the opportunities in Germany?

ARROW: Germans have a different idea of what matters in terms of living standards. And in judging Germany's performance, one must take that into account. Obviously, the negative is high unemployment, which would be hard to justify by any set of values. But consider the pluses: one is leisure. They take longer vacations; the workweek is shorter.

If you were to correct national income

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accounting by valuing leisure at the average wage rate, you would conclude that German per-capita income is not very different from American per-capita income. I believe that German rates of income growth are comparable, measured over any extended period.

And, of course, they have very elaborate medical care providing for everyone's health. One result is that the distribution of income is considerably more equal in Germany than in the United States. So I think, apart from employment, they're doing quite well.

BECKER: Germany's real problems came in the '90s, with the integration of East Germany. The major mistake in integration was the exchange of one East German mark for one West German mark, effectively setting wages near parity in spite of the fact that East Germany's productivity was far below that of West Germany.

Maybe that was necessary politically, but it was a mistake from an economic perspective. One result: Germany is not a country with happy campers. The East Germans resent the West Germans and the West Germans resent the East Germans. Having a brother-in-law and relatives who live in Berlin whom I visit regularly, I see it from both sides.

The older people have very little chance of getting jobs. They are supported mainly by transfers – a surtax on West German income paid to the East Germans. West Germans resent that and East Germans resent it, too. This is a lose-lose situation.

So this is partly an unemployment problem, but one exacerbated by a sharp regional difference. Unemployment in West Germany is maybe 8 percent; in East Germany, maybe 20 percent. And that creates a lot of social friction.

Are the Germans happy with the policy of artificially supporting East German wage rates? I think not. If you look at the last election, it was touch and go whether the Social Democrats would be re-elected. I am not optimistic about the near-term prospects for Germany.

SCHOLES: I hate to always take the negative here, but I think that Germany made some bad mistakes in the 1990s. The banking system is in very bad shape. Banks spent too much for foreign diversification and for supporting activities in Germany, such as the huge expansion of Deutsche Telekom and Daimler-Benz's acquisition of Chrysler.

We do not realize how much Germany paid to bring about the European common currency. Germany was the strongest nation in Europe, as far as debt rates were concerned. Their credit is now supporting the credit of the rest of Europe.

And with a single monetary policy they lost all control of their money supply. Recently they needed to reduce interest rates in Germany, but were precluded from doing it. If you look at real rates of interest, you would be shocked to see how high they are in Europe compared to the United States.

The Germans also signed a deal – the "stability pact" – that says members of the currency union cannot run a primary budget deficit of more than 3 percent of GDP. So in recession, as Germany is today, the government has to cut expenditures. In essence, Germany has lost control of fiscal policy as well as monetary policy.

As a result, there are now so many off-balance-sheet financings in Europe that Enron looks saintly by comparison. Consumption has collapsed because there is a realization that the wonderful social programs to which Ken alluded are not sustainable.

The German system held together as long as growth was rapid. But with slow growth, the stability pact guarantees that something

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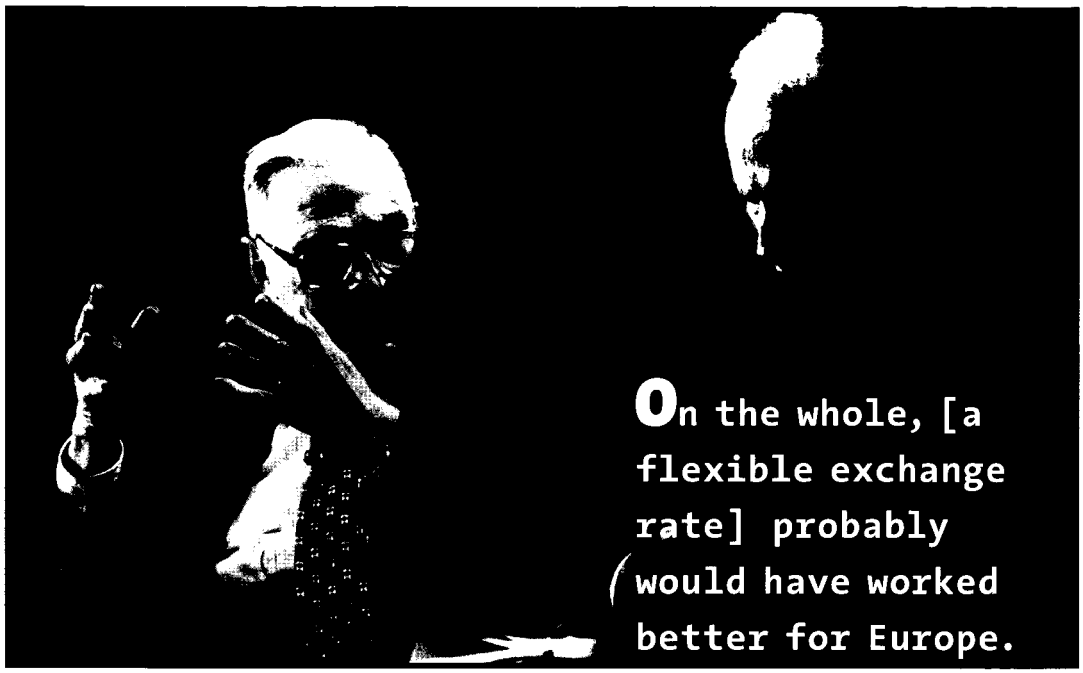
On the whole, [a flexible exchange rate] probably would have worked better for Europe. The British would be well-advised not to join the currency union.

has to give. You are going to have to see both Europe and Japan restructure their pension systems, simply because the promises made are no longer sustainable.

MILKEN: What does this imply about the logic of Great Britain joining the currency union? While we're at it, what lessons do the German experience provide for the unification of Korea?

BECKER: To Britain I would say, "Do not join."

Yes, it is great for Britain to be part of the Common Market. I have been a strong supporter of a system that lets people, goods and capital move freely in Europe. The integration of central and Eastern Europe will only add to the value of the Common Market.

But adopting the euro is another story. And I am not as worried about currency issues as I am about having policy dictated by Brussels. The trend in Europe is toward more centralized government – the opposite of what I'd like to see in as heterogeneous a set of economies as you have in Europe. I think it was Rupert Murdoch who suggested that Great Britain should join Nafta.

MILKEN: Ken, what are your views on Britain and the euro?

ARROW: The common currency was opposed by many analysts – Milton Friedman, for example – for good reasons. One problem is the risk of "idiosyncratic shocks" – if one part of Europe is in recession while other parts of Europe are not, you cannot adjust monetary policy accordingly. If, in addition, you restrict fiscal policy, you really have no way of handling regional differences.

A flexible exchange rate is not a panacea. But on the whole, it probably would have worked better for Europe. The British would

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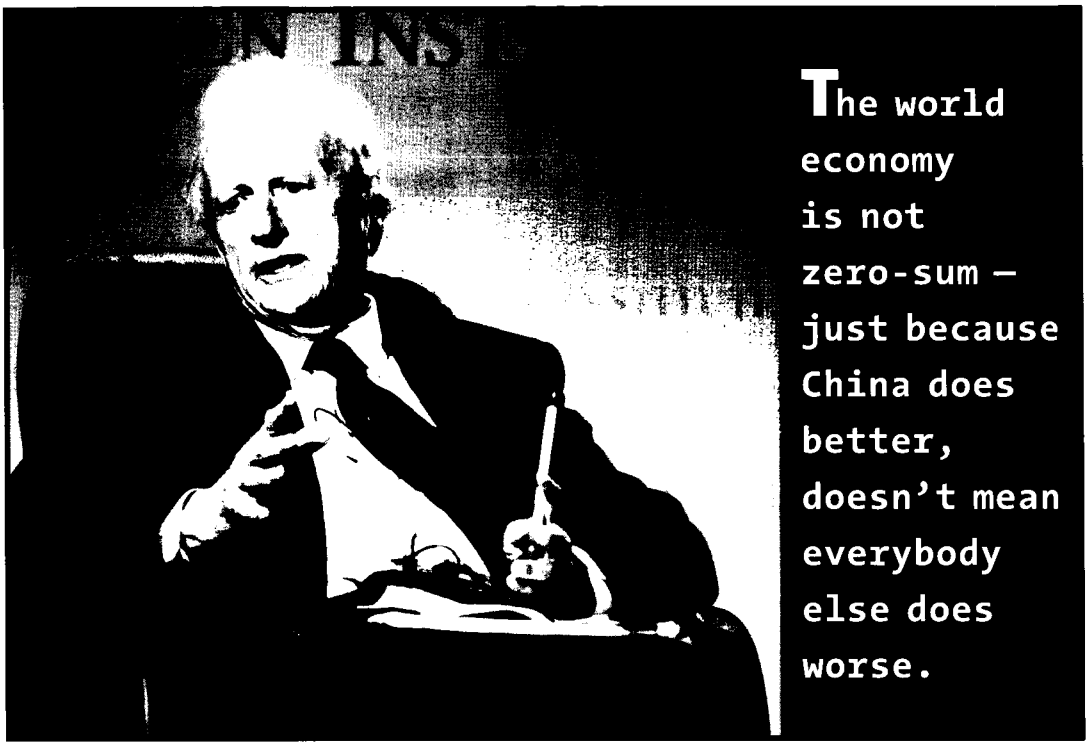

be well-advised not to join the currency union.

MILKEN: Are you suggesting that Great Britain should not be part of the European community?

ARROW: It should not join the European monetary union.

MILKEN: OK, so we have two no's. What about you, Myron?

SCHOLES: I believe that to have a currency bloc of any form, workers must be free to move from region to region and capital has to be highly mobile – that is the way wages, as well as returns to capital, equalize at the margin. When we had the difficulties in Detroit in the '80s, a lot of our human capital moved to the South. There was much more mobility than there is in Europe today.

MILKEN: So is that a yes or a no?

SCHOLES: That is no. A roundabout no, but still a no.

MILKEN: But you have to factor in the benefit of having no more wars.

SCHOLES: You don't need the euro to have peace. You do not need to give up your monetary or your fiscal policy.

BECKER: America had a civil war with a common currency. The war issue, I think, is largely irrelevant here.

MILKEN: What should Koreans learn from the German experience?

BECKER: To separate the economic and the political issues. Korea was once a single country; it has a long history as an independent nation So, at a minimum, Korea needs free markets in goods and capital.

If Korea became a single country, it would face more severe problems than Germany did. South Korean economists estimate that the income gap is much larger than the gap between East and West Germany. What kind of transfer of payments, what kind of taxes should be imposed on South Koreans in order

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to eliminate that gap in a reasonable amount of time?

Germany finances unification with a $100 billion-a-year surtax. In relative terms, more would be needed in Korea.

MILKEN: The population ratios are about the same – about three to one.

BECKER: The relative incomes of East and West Germany were what? One-to-four? That ratio is probably one-to-ten in Korea.

You have to narrow that gap. You cannot have an integrated country where one part is earning one-tenth as much as the other. And the only way you are going to close the gap in the short run is with taxes on the South Koreans to finance the transfers to the North Koreans.

MILKEN: It sounds to me like we are talking about $1,500 per person annual tax in South Korea for a while.

ARROW: That is roughly what the West Germans are paying. I think the Korean figure would be at least that, maybe higher. We are talking about a generation or more before unification can be completed.

MILKEN: Well, let's say it is one generation. One generation's contribution to future generations might be reduced threat of war, reduced threat of nuclear arms…

ARROW: My guess is that South Koreans would willingly bear the burden. But the price is going to be enormous, and probably, a good part of it will be paid by North Koreans migrating south. Something like that is happening in Germany.

MILKEN: Let's turn to prospects for China, one of the great growth areas of the world today. Some developing countries are concerned about the enormous growth of the manufacturing base in China, and the competitive pressure it is putting on them. The other night, Bob Fogel suggested that China could grow at 6 to 8 percent a year for the next 30 years, and at some point, its economy would be larger than [those of] the U.S. and Europe combined.

Is China's growth creating opportunities or challenges for the rest of the world?

SCHOLES: One follow-up point on Korea, first. Taiwan vis-à-vis China is an interesting model for the two Koreas. We have had a lot of Taiwanese trade with mainland China, opening up economic opportunities without political unification.

Opening up trade is one way to start down the path to merger. Obviously, there are still huge political differences between China and Taiwan. It could take a lot of years before China and Taiwan are actually integrated.

SCHOLES: Back to Korea. I was very pleased with what happened after the '97 financial crisis with the collapse of the industrial conglomerates; it has really reinvigorated South Korea.

As far as China is concerned, we have to realize that its GDP is what – 1 percent of the GDP of the United States? So even though it is growing very quickly…

MILKEN: More like 10 percent.

BECKER: Ten to 15 percent.

SCHOLES: All right. I was only off by a factor of 10.

BECKER: And what is 10 percentage points between friends?

MILKEN: About a trillion dollars.

ARROW: Well, excuse me, but China's income is higher than that on a purchasing power basis.

BECKER: And its growth rate is lower than the official statistics. The Chinese say growth is 8 to 10 percent; but it is really something like 5 or 6 percent.

SCHOLES: If you never take note of the losers and just record the winners, you can end up with very rapid measured growth. But the losers – the public enterprises in China – are

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in very bad shape

MILKEN: Myron, I assume you are underlining the issue that without stronger financial institutions and a financial infrastructure in China, ultimately, there will be challenges to rapid growth.

SCHOLES: Right.

MILKEN: And the issues relating to their government-owned businesses are similar to those facing Japan.

BECKER: There is a great deal of concern from American business – from business in general – about the growth in manufacturing in China. But the Chinese are mainly competing against other low-cost producers like Indonesia, which now see China being more productive. The beneficiaries are mainly the consumers in the United States and other countries that import the goods.

The world economy is not zero-sum – just because China does better, doesn't mean everybody else does worse. The growth of China is going to harm some companies and some industries elsewhere, but it is also going to generate enormous benefits.

ARROW: I agree about trade. I heard a talk on the manufacture of men's clothing – men's jackets. It turned out the jacket was designed in Japan, and parts of it were made in China. The sleeves were sewn on in Malaysia…

MILKEN: And it came with an Italian name on it, right?

ARROW: I agree with Gary that 6 to 8 percent growth cannot continue for very long. There are some real contradictions in the Chinese system, if I may use an old Marxist expression, which will only be overcome at a high price.

One of these is the role of state-owned enterprises. They are shrinking in relative terms, but only because the rest of the economy is growing. A large amount of money is still going into these moribund dinosaurs. Also, the political structure and the legal structure are simply out of line with the economy. So I think there are going to be some painful constrictions at some point, when growth is going to be inhibited by the funneling of resources into support of the political structure.

The other problem is that prosperity forces wrenching changes in the industrial structure. As wages rise, comparative advantage in labor-intensive industries like clothing is reduced – which is what happened to Japan. There is no reason for it not to happen in China.

BECKER: Let me just say we all disagree with my good friend and colleague Bob Fogel. China is not going to continue to grow at 8 percent for 30 years.

MILKEN: To summarize, you've raised three different issues that lead to questions about China's long-term economic prospects. One is the strength of the financial system. Two is the persistence of state-owned enterprises. And three is the inconsistency between the political system and modernization.

Let's move on to other topics. One is the U.S. deficit – its effect on the economy, its relationship with homeland security.

BECKER: We are going to be running significant deficits, whether or not the Bush tax cuts get implemented. The deficits will have a number of consequences. They will reduce future government spending, as interest on debt forces a cutback regardless of which party is in power.

I would like to see a cut in spending, because I think the government is too large. But deficits may also raise interest rates, and that would be a negative.

Regarding terrorism and war, they obviously have a negative impact on the economy. Anybody who says that war is going to

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improve the economy is talking nonsense.

But you have to phrase the question carefully: to judge the impact of war, you must have an alternative in mind. If the standard is a cheap peace, any war alternative is going to cut consumption and investment. On the other hand, if you believe (as I do) that a containment policy for Iraq might well have led to a future war with more powerful weapons – then maybe the war was a good investment.

MILKEN: Switching to another subject, one of the strengths of the United States has been the perception that every person has a chance to earn a middle-class living, to send his children to college, to own a car, a house, etcetera. Has a system in which most of the economic rewards go to those with skilled jobs changed things?

ARROW: There is no question that income distribution is becoming less equal. Part of the reason is the widening gap between the wages of the skilled and unskilled. But that is not the whole story.

The dispersion of incomes within groups with comparable skills is also increasing for reasons we do not fully understand. Changes in the knowledge structure and in foreign trade have something to do with it. Immigration is part of the story, too.

Not only is income inequality rising, but those at the low end are actually losing ground in absolute terms. That, I think, is a real problem.

This is not the result of government policies. But the government does have some obligation to remedy it by changing the tax structure. Taxing those at the high end won't reverse the trend, but it could mitigate its impact.

Economic mobility at the upper end – say, the chances of moving from the upper 60 percent of the distribution to the upper 90

Not only is income inequality rising, but those at the low end are actually losing ground in absolute terms. That, I think, is a real problem.

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percent – is probably as good or better than it ever was. But for all sorts of reasons, including changes in family structure, there is less mobility from the bottom to the middle. Increasing this mobility should be an object of government policy – particularly, education policy. That is why I don't agree with Gary about government spending.

BECKER: Don't create a straw man...

MILKEN: One of the themes that has come up repeatedly at the Global Conferences, has been the persistence of two worlds: just 15 percent of the world's population consumes 85 percent of the world's output.

The issues of terrorism and contagious disease force us to recognize how small our planet is today. We have not really been successful in bringing strong economies to some critical parts of the world: Pakistan, Egypt, Nigeria, Indonesia.

I take as a given that quality of life in the developed world is highly dependent upon opportunity for prosperity for all the people on the planet. What are the two or three things we could do to bring the have-nots on board?

SCHOLES: Legal infrastructure is crucial. If you have no rule of law, if you have the Mafia or whatever running the show, there can't be growth.

Second you have to have education and, also, economic specialization. India has come to life because of education; computer programmers and the like can add a lot of wealth by specialization.

Third, if you have specialization, you also need a way to hedge risk. The U.S. economy is highly diversified, so if some industries are in bad shape, others will take up some of the slack.

BECKER: If you look at the degree of inequality across families rather than countries, you find much more optimistic developments in the last 30 years.

There is a very good paper by Columbia University economist Xavier Sala-I-Martin, in which he calculates world inequality on a family basis, rather than a country basis. He finds significant declines in income inequality. This is partly, but not wholly, due to growth in China and India.

I would also note that national income accounts are an imperfect measure of people's well-being. Among other things, they leave out improvements in life expectancy. In the last 40 years, longevity in the poorer parts of the world has increased more rapidly than the richer parts of the world. When you factor in this change, you find considerable convergence in income distribution.

MILKEN: In the last 40 or 50 years, life expectancy has increased by about 10 years in the wealthier countries and by about 20 in the poorer countries. The gap today is only about 10 years.

BECKER: So while there are lots of bad things happening to income distribution, there are also a couple of encouraging signs.

ARROW: I agree 100 percent with Gary that, when you take into account China and India, there has been some convergence. Of course, that is after a century of increasing divergence. Sub-Saharan Africa is still a disaster area, where things are getting worse in every dimension you can think of.

Trade protection for agriculture – particularly in advanced countries – is a very serious impediment to reducing inequality. It is preventing significant growth in export earnings for many countries, particularly in Africa. So while poor countries have to reform their own economies, we have a responsibility to let them to grow through exports.

MILKEN: Well, I want to thank all of you. Thanks very much.

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Creative Destruction

BY TYLER COWEN

Arguably, America has never before been loved by so many and reviled by so many others. The paradox applies to America's role in culture as well as to its reach in economics and geopolitics: never have so many denounced the dominance of American music, books, games and movies, even as they rushed to buy the objects of their derision. ¶ Hence the relevance of Tyler Cowen's book *Creative Destruction: How Globalization is Changing the World's Cultures.** Cowen, an economist who teaches at George Mason University in Virginia, offers a free-market perspective on the question of whether American-led global integration is enriching or impoverishing local cultures. ¶ His conclusions may not shock, in light of his affiliation with a leading center for conservative thought. But the subtlety and evenhandedness with which he surveys the role of economic forces in molding culture will surprise those who don't know his earlier work. Here, we excerpt the chapter entitled "Why Hollywood Rules the World, and Whether We Should Care."

— *Peter Passell*

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Cinema is one of the hard cases for globalization. When we look at world music, the visual arts or literature, it is readily apparent how trade has brought a more diverse menu of choice and helped many regions develop cultural identities. In each of these cultural sectors, the market has room for many producers, in large part because the costs of production are relatively low.

But what about film? In no other cultural area is America's export prowess so strong. Movies are very expensive to make – there are far fewer films released than books, CDs or paintings. These conditions appear to favor dominant producers at the expense of niche markets. So if cross-cultural exchange will look bad anywhere, it is in cinema.

Moviemaking is also prone to geographic clustering. Many cultural innovations and breakthroughs are geographically concentrated. If a good Italian Renaissance painter was not born in Florence, Venice or Rome, he typically found it worthwhile to move to one of those locales. An analogous claim is true for Hollywood, which attracts cinematic talent from around the world, strengthening its market position.

The degree of clustering has reached such an extreme, and Hollywood movies have become so publicly visible, as to occasion charges of American cultural imperialism. European movies, in particular, have failed to penetrate global markets and have also lost ground at home. Many individuals claim that, when it comes to cinema global culture is a threat rather than a promise.

To what extent is movie production clustered in Hollywood and why has such clustering taken place? Why is European cinema so economically moribund? Have other national

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cinemas fared badly as well? Is cinematic clustering inimical to diversity? Most generally, has cross-cultural exchange damaged diversity in cinema?

WHY CLUSTERING IN HOLLYWOOD?

The current malaise in European cinema is caused by a concatenation of unfavorable forces involving television, excessive subsidies, demographics, language, market size and Hollywood's more entrepreneurial environment. While some charges can be pinned on globalization, cross-cultural exchange is not the primary culprit.

The United States has at least one natural advantage in moviemaking: the largest single home market for cinema in dollar terms (although total attendance is higher in India). The countries that specialize in moviemaking tend to be those in which movies are most popular – America and India. Home audiences often prefer native products, if only for

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reasons of language and cultural context, and this encourages production to shift to that market.

Market size is nonetheless just one factor in determining who becomes a market leader. The United States, for example, has been a large country for a long time, but only recently have European movies held such a low share of their home markets. In the mid-1960s, American films accounted for 35 percent of box office revenues in continental Europe; today the figure ranges between 80 and 90 percent.

The greater population of the United States, and the greater American interest in moviegoing, do not in themselves account for these changes. Furthermore, only certain kinds of cinema cluster in Hollywood. In a typical year, Western Europe makes more movies than America. In numeric terms, most of the world's movies come from Asia, not from the U.S. It is not unusual for India to release 900 commercial films a year, compared to about 250 from the United States.

The Hollywood advantage is concentrated in one very particular kind of moviemaking: films that are entertaining, highly visible and appeal to a broad global audience. The typical European film has about 1 percent of the audience of the typical Hollywood film, and this difference has been growing. American movies have become increasingly popular in global markets, while European movies have become less so.

Not surprisingly, the Europeans invest less in each film than do Hollywood producers. One estimate from the early 1990s placed the average European film budget at $3 million and the average American film budget at $11 million. The average film budget for a major Hollywood studio (as opposed to an independent) is about $34 million. Moreover, these numbers omit marketing and audience research budgets, the area in which American moviemakers outspend their European counterparts most. For an average Hollywood movie, the marketing budget runs at least $30 million. European estimates are hard to find, in part because the numbers are so small.

The question is not why Hollywood makes more movies than Europe, because it does not. The question is why Hollywood movies have more success as exports, while European movies are aimed at small local audiences. As recently as 1985, French movies outgrossed the Hollywood product in their home market. Hollywood's success in capturing up to 80 percent of the French market has come largely because French revenues have declined, not because Hollywood revenues have risen.

The turning point was in the 1970s. Thereafter, European moviemakers have seen their export markets collapse. In essence, Hollywood is now competing with the native European producers in each country, rather than with cross-European exports.

The popularization of television, and the timing of this popularization, damaged European cinema. As television became widespread throughout Europe, movie audiences dwindled. Germans bought 800 million movie tickets in 1956, but only 180 million in 1962. Meanwhile, the number of television sets rose from 700,000 to 7.2 million.

In the United Kingdom, cinema audiences fell from 292 million in 1967 to 73 million in 1986. In France, attendance dropped from 450 million in 1956 to 122 million in 1988. In Japan, sales of movie tickets in 1985 were just a sixth of sales 25 years earlier.

This demand shock forced European moviemaking to contract. Hollywood stepped into the void, just as it did during and after World War I – an earlier period of crisis in European cinema. Hollywood became strong when European competitors were

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most vulnerable.

American moviemakers had suffered a similar audience collapse – but much earlier, due to the more rapid spread of television in the United States. The U.S. film audience declined by 50 percent, but this happened over the 1946-1956 period rather than later, as in Europe. By 1955, two-thirds of American households already had television sets.

A self-reinforcing dynamic has since expanded Hollywood's export advantage. American success led to easier finance and greater marketing expenditures, which in turn led to greater export potential. Hollywood films have become increasingly global, while Europeans target small but guaranteed revenue sources such as state subsidies and television rights sold to government-regulated stations. A vicious cycle has thus been created: the more European producers fail in global markets, the more they rely on domestic television revenue and subsidies. The more they rely on television and subsidies, the more they fail in global markets.

The Hollywood advantage is concentrated in one very particular kind of moviemaking: films that are entertaining, highly visible and appeal to a broad global audience.

Starting as early as the 1950s, American moviemakers responded to television by making high-stakes, risky investments in marketing, glamour and special effects. In the 1960s American directors found greater latitude to experiment with sex and violence; this trend was formalized with the abandonment of the Hays Code in 1966. By the 1970s, Hollywood movies had become significantly more exciting to mass audiences than they had been a decade before. *Jaws* and *Star Wars* were emblematic of this new era.

Demographics have worsened the problems of European moviemakers, since moviegoing is so much the province of the young. Most European countries suffer twice over here. First, they have older populations than the United States. Second, the traditional "art house" style of European film is especially hard to export, because it is better suited to older audiences than to younger ones. The advent of the multiplex, which tends to attract the young more than the old, has added to the problem.

Television has cut into the American and European film markets in a different fashion. Video rentals are a more important income source in the American market, whereas the sale of television rights plays a bigger role in Western Europe. U.S. figures (circa 1993) place pay and free television at 19 percent of film revenues, movie theaters at 27 percent and home video at 49 percent. In contrast, television accounts for more than half of film revenue in the French market. Not every European country exhibits the same dependence on television, but France is by far the biggest movie producer in Europe and accounts for roughly half of all Western European movie output by dollar value. The problems of European cinema are, in large part, the problems of French cinema.

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Reliance on broadcast television makes European movies less suited for the export market. Many TV viewers turn on the set and watch whatever is on. This does little to enforce high standards of quality.

Production for the television market thus tends towards the mundane and the formulaic. Glitzy special effects are rare. The same holds true in made-for-TV films in the United States. A few are excellent (such as Steven Spielberg's early *Duel*), but most are undistinguished. Most of all, made-for-TV movies are not well suited for export to large audiences. Europe simply produces more low-end, destined-for-TV movies than the United States, regardless of the claimed pretense of theatrical release.

The home video market, more prominent in the United States, is more competitive and demanding than television, and imposes greater discipline on the moviemaker. Customers must be induced to go out and rent a movie in the first place. Then they can choose from among thousands of competing titles.

The U.S. also has a more competitive television market due to the larger number of cable channels, which require higher standards. In the United States, the television and video markets serve as handmaidens for the theatrical market, augmenting its influence over the quality of the product. While some movies succeed on video alone, video success typically depends on the publicity generated at the box office. The same can be said for the sale of U.S. television rights.

Theatrical revenue thus drives both video revenue and television revenue in the American market. In Europe, by contrast, television revenue is more likely to be a *substitute* for theatrical revenue. European films, which experience major successes at the box office far less frequently, are more likely to be placed on television as filler.

The roles of television and subsidies are closely linked. Most Western European nations have television networks that are owned, controlled or strictly regulated by their governments, which use them to promote a national cultural agenda. Typically the networks face domestic-content restrictions and must spend a minimum percentage of revenue on domestic films.

The result is overpayment for broadcast rights – the most important subsidy that many European moviemakers receive. Audiences are typically no more than one or two million at the television level even in the larger countries such as France – too small to justify the sums paid for rights.

European films receive many other forms of subsidy. In France, for instance, direct subsidies are available from the national government, regional governments, European subsidy bodies (such as Eurimages) and co-production subsidies through other national governments.

French producers also receive "Sofica" tax shelters (with an estimated value of more than 5 percent of total budgets), automatic box office aid from the government (estimated at 7.7 percent of total budget), a discretionary subsidy called *avance sur recettes*, which takes the form of an interest-free loan (estimated at over 5 percent of total budget) and subsidies for the promotion of French films abroad. A 1970 study estimated that 60 percent of the *avance* subsidy was, in fact, never recovered. The bottom line: French producers often need put up only 15 percent of the budget of their films.

Money is also advanced for the development of new film ideas and for script rewriting, if the proposed film is rejected when the producer applies for subsidies on the first go-round. There is a special subsidy fund for projects co-produced with Eastern European

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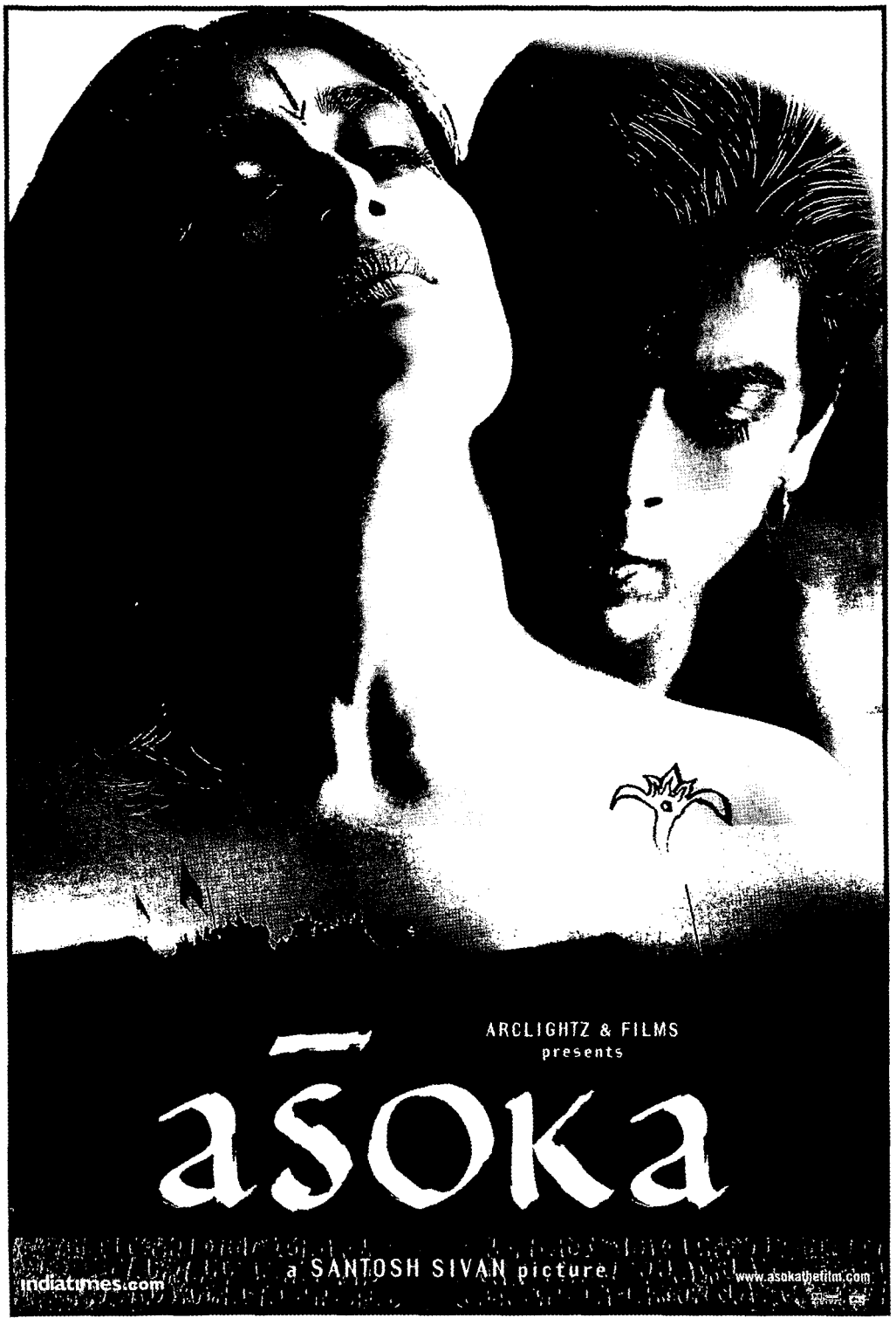

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filmmakers. The French government also subsidizes the upkeep and construction of theaters – an indirect subsidy to moviemakers – and encourages French banks to lend for movie projects. A number of other French institutions are not formally state-controlled but act in conjunction with the state system, subsidizing scriptwriters, directors and production companies.

Martin Dale, a cinema industry analyst, has estimated that, taking all subsidies into account, the state provides at least *70 percent* of the funding for the average Continental film. This estimate is speculative because the wide variety of subsidy schemes, and their complex nature, makes their final impact difficult to trace. Nonetheless, subsidy-granting bodies provide more than supplemental assistance – they have become the industry's primary customer.

This leads producers to serve domestic demand and the wishes of politicians and bureaucrats, rather than to make movies geared toward international audiences. Many films will be made, even when they have little chance of turning a profit in stand-alone terms. Moreover, the market structure undermines incentives to develop specialized talents in marketing, as Hollywood has done.

The training of cinematic talent in the United States and Europe reflects these differences. American film schools are like business schools in many regards. European film schools have become more like humanities programs, emphasizing semiotics, critical theory and contemporary left-wing philosophies. The European directors that survive tend to be established and to have longstanding political connections; one 1995 study estimated that 85 percent of the film directors in France were over 50 years of age. Younger talents set their sights on Hollywood from the beginning, rather than staying at home to develop a domestic cinema.

The two non-Hollywood film industries that have enjoyed the most export success – India and Hong Kong – are run on an explicitly commercial basis. Some segments of the Indian film industry receive government subsidies, but the overwhelming majority of new releases are not assisted. They are commercial productions made for profit and frequently exported, usually to other underdeveloped nations but often to the United Kingdom as well. By numerous measures, such as attendance or number of films released, the Indian movie industry is the largest and the most successful in the world. Indian movies are frequently criticized for their generic nature and sappy plots, but in terms of music, cinematography and use of color, they are often quite beautiful – even pathbreaking.

The Hong Kong film industry has been a successful exporter, mostly to Southeast Asia, since the 1970s. At its peak it released more films per year than any Western country, and was second only to the United States in exports. Furthermore, Hong Kong cinema arose in a market that was dominated by Hollywood through the late 1960s. In the 1970s and 1980s, however, Hollywood sometimes failed to capture even 30 percent of the domestic Hong Kong market. Only since 1997, when Hong Kong was returned to China, did Hollywood movies capture more than half the local box office.

At first, Hong Kong movies focused on the martial arts, but subsequently branched out to include police movies, romance, comedy, horror and ghost stories, among other genres. The best, such as John Woo's *The Killer* and *Hard Boiled*, are acclaimed as high art and have had considerable influence on directors around the world. In recent times, however, the industry has been damaged by fears of censorship.

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Many of the complaints about American cultural imperialism have a Eurocentric slant. Today's mainstream European cinema does appear less vital than its 1950-70 counterpart. But by most common critical standards, cinematic creativity has risen in Taiwan, China, Iran, South Korea, the Philippines, Latin America and many parts of Africa, among other locales. Even within Europe, the creative decline is restricted to a few of the larger nations, such as France and Italy.

Danish cinema is more influential and more successful today than in times past, and arguably the same is true for Spanish cinema as well. Mexican and Argentinean filmmakers are enjoying a resurgence. While these producers all struggle against Hollywood competition, world filmmaking is not on a downward trajectory.

THE ENGLISH LANGUAGE, AND THE MOVE FROM SILENTS TO TALKIES

Cinematic clustering, and the current crisis of European cinema, is in part rooted in the transition from silent film to talkies. Counterintuitively, the onset of the sound era increased Hollywood's share of world cinematic revenue. Equipping theaters for sound was costly. To recoup these costs, theater owners sought out high-quality productions for large audiences. The cheap, quick film became less profitable, given the higher fixed costs of production and presentation.

This shift favored Hollywood moviemakers over their foreign competitors. More generally, the higher the fixed costs of production, the greater the importance of marketing skills. Today, costly special effects and expensive celebrity stars drive the push for blockbusters and favor Hollywood production, as well.

By introducing issues of translation, talkies boosted English as the dominant world language and thus benefited Hollywood. Given the growing importance of English as an international language and the focal importance of the United States, European countries would sooner import films from Hollywood than from one another. A multiplicity of languages often favors the dominant one, which becomes the common standard of communication.

Hollywood executives properly regarded the transition to talkies as an opportunity to expand abroad, rather than as a cause for trepidation. At the time of the transition, some movie executives speculated that talking pictures would make English the language of the entire world, which has turned out to be only a modest exaggeration. Once America, and the English language, became established as a world standard, the process proved self-reinforcing. American audiences, the world's largest at the time, became accustomed to seeing films in their native language. Dubbed or subtitled movies have a difficult time in the United States to this day, whereas most other audiences accept them with little complaint.

This difference in linguistic expectations means that European moviemakers have a much harder time penetrating the American market than vice versa. The American export advantage is thus based on a combination of outward-looking producers and inward-looking consumers.

The rise of English as an export standard provided a strong boost to movies from Great Britain. While the U.K. has never seriously rivaled Hollywood as a moviemaking power, many U.K. releases have succeeded on a global scale by mimicking the Hollywood style. The James Bond movies and David Lean's *Lawrence of Arabia* or *The Bridge on the River Kwai* fit the category.

Today, the United Kingdom is the leading European exporter of movies to other Euro-

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pean nations. In 1991, the U.K. put out 36 movies, 56 percent of which were exported to France. In the same year, France put out 140 movies, only 14 percent of which were exported to Britain. Italy, Spain and Germany have export performances that are far worse than the French record.

Not surprisingly, U.K. moviemakers spend more per film than anywhere else in Europe and rely less on subsidies than their Continental counterparts. U.K. producers have also been geared to export for a long time. Given how much of their home market is captured by Hollywood, U.K. features must reap export revenue to turn a profit.

We see tendencies toward a common linguistic standard in other cinematic markets as well. Numerous dialects are spoken in Arab countries. This has helped Cairo, through the use of Egyptian Arabic, to attain a position as the dominant movie exporter to other Arab nations. Egyptian Arabic is now widely understood around the Arabic world, in large part because non-Egyptians receive so many movies and television programs in the language. This audience is now more likely to patronize the Egyptian product, which makes it harder for other Arab nations to compete.

India has 15 languages and 2,000 dialects, but the Hindi cinema of Bombay dominates cross-regional markets within India. While more films are made in Madras and other locales, Bombay films command most of the investment, attract the biggest stars, have the greatest national following and the greatest success abroad. The Philippines has many languages as well, but Tagalog has priority in cinema.

The move to talkies provides a natural experiment in isolating the importance of

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language. In the silent era, of course, language simply was not an issue. In essence, talkies made it easier for non-Hollywood producers to capture part of their home markets, but made it harder for them to export. European movies commanded a greater share of their home markets in the 1930s, compared to the silent era. The domestic markets offered a certain percentage of "captive" viewers who preferred their native language. So, given the greater ease of pleasing the home market and the greater difficulty of exporting, European moviemakers turned inward.

The move to talkies provides a natural experiment in isolating the importance of language.

French film production doubled between 1928 and 1938, and French movies commanded over half of the domestic market throughout the 1930s. In 1936, the six most popular films in France were all French. Of the 75 most popular films, 56 were French, compared to 15 from America. In 1935, 70 percent of all film receipts in France went to French-produced movies. By comparison, at the height of the silent era (1925), American exports accounted for 70 percent of the French market.

The sound era offered the greatest relative benefits to the national cinemas that were not exporting much in the first place. Cinema blossomed in Hungary, the Netherlands, Norway, Mexico and Czechoslovakia, among other places. The Hong Kong cinema started in the 1930s, and used the Cantonese dialect as its primary selling point in southern China. In contrast, Sweden and Denmark, which were significant movie exporters in the silent era, did not fare nearly as well with talkies.

Sound also transformed movies through the introduction of recorded music. Indeed, film music was a greater lure for Indian audiences than dialogue, and arguably remains so to this day. Hollywood has no comparative advantage at producing high-quality Indian popular music. Indian producers marketed their films domestically on the basis of Indian music, and quickly developed new centers of cinematic production in Bombay, Calcutta and Madras.

Music provided a similarly protective role in Argentina, where hundreds of musical comedies were made in the early years of sound film. The Argentinean Carlos Gardel, more tango singer than actor, became the hottest Latin cinematic star of his era.

Hollywood has never had a strong comparative advantage in producing musicals for foreign audiences, and its international influence has been limited accordingly. The general decline of the musical, however, has weakened an area in which national cinemas traditionally held their own against Hollywood exports.

THE DRIVE TOWARD CLUSTERING

In part, movie production clusters because there is no reason *not* to cluster. When the cost of shipping is low, clustering makes economic sense. Consider a more general economic analogy. There is more trade and mobility across the U.S. than across the disparate countries of Western Europe. This trade causes the economic profiles of the American states to diverge. In economic terms, the countries of Western Europe are more likely to resemble each other than are

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the American states.

Most of the American states have no steel industry, no automobile industry and no wheat industry; instead they buy these products from other states or countries. But typically, a nation in Western Europe has its own steel, automobile and agriculture sectors, largely because of subsidies and protectionism. Free trade within the U.S. allows states and regions to specialize and causes their economic profiles to diverge. In a freer economic environment the economies of Western Europe would take the same path.

Trade and specialization thus bring geographic clustering when the product is mobile. Most American peanuts are grown in Georgia and Virginia and then shipped to the rest of the country. In contrast, each region of the United States manufactures cement, as does each European country. The costs of trading and transporting cement are too high for clustered production to be feasible. Action movies, however, resemble peanuts more than cement, especially if the film appeals to many cultural groups.

Some of Hollywood's cinematic clustering is driven by the short-run, dynamic nature of film projects. Studios may dally over projects for years, but once the go-ahead decision has been made, the moviemakers move as quickly as possible to minimize costs and to meet a perceived market demand. They need to assemble large numbers of skilled employees on very short notice, and therefore they will "fish" for talent in a common pool.

In similar fashion, the computer industry changes rapidly, many projects are short term, and once a go-ahead decision has been made, large numbers of talented employees must be assembled rapidly. Common forces therefore shape the clusters of Silicon Valley and Hollywood.

It is not always the case that movies can be *filmed* more cheaply in Hollywood than elsewhere. In fact, Hollywood craft workers are worried about their jobs being outsourced to Canada, Australia and other non-U.S. locales where production costs are lower.

Rather, clustering reduces the cost of finding, assembling and evaluating a movie's critical assets, such as stars, directors and screenplays. These tasks are still done in Los Angeles rather than in Vancouver or Sydney, regardless of where the movie is filmed. The Hollywood cluster has a superior ability to evaluate cinematic projects and, in particular, to design and market the product for maximum profits. Hollywood is the geographic center for these talents.

Ironically, it is easier to get a film made in Europe than America. Hollywood studios scrutinize projects intensely and refuse to finance projects that do not have a good chance of commercial success. But most European moviemakers do not apply similar filters.

Hollywood is a cluster, in part, for the same reasons that New York and London are clustered banking centers. In both cases, talents for large-scale project evaluation gravitate toward a single geographic area.

Moviemaking has become more expensive over the past 30 years, due largely to special effects, rising celebrity salaries and marketing expenditures. All of these changes have increased the relative value of skills in demand forecasting and project evaluation. They have increased the natural advantage of Hollywood.

New clusters often generate snowball effects, attracting yet more talent to the commercial center. When European directors want to make popular movies they now go to Hollywood, as we have seen with Ridley Scott, Paul Verhoeven, Bernardo Bertolucci and Jean-Jacques Annaud, among many others. Initial differences thus become self-sustaining

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rather than self-limiting. For this reason, one "turnaround" event can shift a cluster from one locale to another.

The French lost their dominant market position in cinema only with World War I, which led the major combatants to virtually cease film production for four years. Hollywood filled the vacuum, first penetrating world markets on a large scale in the 1920s. The snowball effect shifted the direction of the industry's momentum, and the United States rapidly surpassed France as the world's largest movie exporter in only a few year's time.

CLUSTERING MYTHS

It is widely believed that America dominates world cinematic markets because it has monopoly power in film distribution. Yet all the primary distributors in Europe are owned by European media groups and regulated by European governments. When the Cineplex Odeon theater chain in the United States was Canadian owned, and for a while jointly Canadian and British owned, it made little difference on the screen.

A second myth is that Hollywood dominates because it can sell its movies so cheaply abroad, having recovered costs in the home market. In other words, a movie can be dumped abroad since "it has already been paid for." This argument does not explain America's market share. At most, it explains why Hollywood films are booked by theaters – not why they are so popular with audiences.

When European consumers choose between an American and an indigenous production, the ticket prices are typically the same. American dominance arises because European consumers prefer American movies. If the critics were correct that Hollywood's fundamental advantage is on the cost side for film rentals, we should observe relatively empty theaters for American films in Europe. The cheapness of Hollywood films would cause so many films to be imported that the marginal Hollywood film would draw a small audience. Those films would be valued mostly for low rental fees, not for their popularity.

But we do not observe this outcome. Indeed, when American movies are shown in Europe, the critics complain that the theaters are full. If Hollywood dominated the market on cost grounds, rather than on popularity grounds, Europeans would not fear cultural imperialism – as they plainly do.

WHY HOLLYWOOD RULES THE WORLD

The argument that Hollywood movies have "already been paid for" has another logical flaw. Movies from all countries have already been paid for, once they are made. The fundamental issue is what gets made in the first place, and what then gets shown abroad – and that depends on consumer demand. So many Hollywood movies are made, and with such high levels of funding and marketing, because they can draw large audiences. Similar arguments apply to other media industries – for example, Canada claims that American television shows and magazines can be dumped at very low cost because the producers are already making a profit in the U.S. market.

But again, we typically do not observe American products preferred for their cheapness; they are preferred for their superior entertainment value. A more persuasive version of the argument follows from the fact that suppliers with a large home or captive market often can afford to make better products. They can invest more money in quality, and earn the investment back on ticket sales more easily. Films from Burkina Faso do not have expensive special effects. This argument, however, leads us back to the conclusion that

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FROM THE DIRECTOR OF ALIENS, ALIEN 3 AND THE ABYSS
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NOTHING ON EARTH COULD COME BETWEEN THEM.

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more expensive movies are better movies, at least in the eyes of the audience.

In the case of television, the dumping argument is ironic. To the extent that Hollywood TV programs and movie rights have been sold cheaply in Europe, it is because European TV stations have held a strong bargaining position (a "monopsony" in economic language). Until the recent partial deregulation of European television, the number of program buyers in a single country has sometimes been as small as one or two government-owned or controlled channels. Through bargaining, the single buyer could limit the price paid for Hollywood content.

Ironically, the sale of Hollywood movies to television at bargain prices has, in the past, subsidized the state-controlled, non-commercial products of European television. if European buyers lacked monopsony power, the price of movie rights would be bid up to reflect the potential popularity of the movie.

Note that America has had much less success in exporting television programs than movies, even though it has the largest domestic television market in the world. The popularity of domestic television programs is robust; even the African nations command a reasonable share of their domestic television markets. While some American shows have been exported successfully, they are rarely hits in every country; *Dallas* was a failure in Brazil and Japan.

American television programs show no sign of taking over the world, and in many countries are losing market share. In 1998, for example, American television programs were unable to crack the top 10 in any of the major Western European markets. In part, this is because TV faces a more passive audience and need not meet the exacting technical standards of the cinematic medium. Hollywood has never had a strong comparative advantage at producing relatively low-cost drama. In some genres, such as the soap opera, Brazil and Mexico have proven more effective exporters than the United States – again showing the special and limited nature of the Hollywood advantage in international markets.

More expensive movies are better movies, at least in the eyes of the audience.

America cannot even dominate the market for Spanish-language television, even though the 30 million or so Latinos in the United States are the single largest Spanish-language audience in terms of purchasing power. The Miami-based stations, Telemundo and Univision, import most of their dramatic programs from Mexico and South America, rather than making them in the United States. As a result, some U.S. Latinos have complained of "cultural imperialism," wishing instead for a homegrown Miami product.

AMERICAN CULTURAL IMPERIALISM?

When Hollywood penetrates global markets, to what extent is American culture being exported? Or is a new global culture being created, above and beyond its specifically American origins?

There is no simple answer. Critics of cultural imperialism make two separate and partially contradictory charges. Some are unhappy with the global spread of the American ethos of commercialism and individualism. Others focus on the strong global market

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position of a relatively universal cultural product, rather than local products based on national or particularist inspirations. There is some truth to each complaint, although they point in opposite directions.

If we look at the national identities of the major players, Hollywood is highly cosmopolitan. Many of the leading Hollywood directors are foreigners by birth, including Ridley Scott (British) and James Cameron (Canadian), who were among the hottest Hollywood directors circa 2001. Arnold Schwarzenegger, Charlie Chaplin and Jim Carrey have been among the leading non-American U.S. stars.

Most of the major studios are now foreign-owned. A typical production will have Sony, a Japanese company, hire a European director to shoot a picture in Canada and then sell the product for global export. Of the world's major entertainment corporations, only AOL Time Warner is predominantly American in ownership.

For better or worse, Hollywood strives to present the universal. As Hollywood markets its films to more non-English speakers, those films become more general. Action films are favored over movies with subtle dialogue. Comedy revolves around slapstick rather than verbal puns. The larger the audience, of course, the more universal the product or the star must be. There is relatively little that the world as a whole, or even a select group of 50 million global consumers, can agree on.

Greater universality means that movies are relevant to general features of the human condition, but it also can bring blandness and formulaic treatment. Critics allege that American culture is driving the world. But in reality the two are determined simultaneously, and by the same set of forces.

When they pursue foreign markets, non-American movies must strive for universality as well. Jackie Chan's Hong Kong movie *Rumble in the Bronx* was successfully marketed in the United States. The producers, however, cut parts of the movie to appeal to American audiences. All of the action sequences were kept, but the relationship of Chan with the co-star was diminished, in part because the woman (Anita Mui) was a star in Asia but not in the United States, and in part because the relationship was based on the "Chinese" values of obligation and loyalty, rather than on a Western sense of erotic romance.

The most successful Canadian cultural export is the Harlequin romance novel. In 1990, Harlequin sold more than 200 million books, accounting for 40 percent(!) of all mass-market paperback sales in the United States. This fact is rarely cited by Canadian critics of American cultural imperialism, largely because Harlequin's export success does not "count" for them. The romance novel does not reflect a specifically Canadian perspective, whatever that designation might mean, but rather targets a broad circle of female readers.

Despite these powerful universal forces, the American and national component to Hollywood moviemaking cannot be ignored. Hollywood has always drawn on the national ethos of the United States for cinematic inspiration. The American values of heroism, individualism and romantic fulfillment are well suited to the large screen and to global audiences.

It is true that Hollywood will make whatever will sell abroad. Nonetheless, *how well* Hollywood can make movies in various styles will depend on native sources of inspiration. Hollywood has an intrinsic cost advantage in making movies based upon American values, broadly construed, and thus has an intrinsic advantage in exporting such movies. The

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clustering of filmmaking in Hollywood cannot help but be based in part on an American ethos. For this reason, dominant cultures such as the United States have an advantage in exporting their values and shaping the preferences of others.

Consider the market for prepared food. Many third-world citizens like to eat at McDonald's, not just because the food tastes good, but because McDonald's is a visible symbol of the West and the United States. When they walk through the doors of a McDonald's, they enter a different world. Knowing this, the McDonald's Corporation designs its interiors to reflect the glamour of Western commerce, much as a shopping mall would. McDonald's shapes its product to meet global demands, but builds on the American roots of the core concept. The McDonald's image and product lines have been refined in the American domestic market and draw heavily on American notions of the relation between food and social life.

The promulgated American ethos will, of course, meld national and cosmopolitan influences, and will not be purely American. American cinema, like American cuisine, has been a synthetic, polyglot product from the beginning. Hollywood was developed largely by foreigners – Jewish immigrants from Eastern Europe – and was geared toward entertaining American urban audiences, which were drawn from around the world.

Furthermore, Hollywood's universality has, in part, *become* a central part of American culture. Commercial forces have led America to adopt "that which can be globally sold" as part of its national culture. Americans have chosen to emphasize their international triumphs and their ethnic diversity as part of their national self-image. In doing so, Americans have, to some extent, traded away particularist strands of their culture for success in global markets.

In this regard, Hollywood's global-market position is a Faustian bargain. Achieving global dominance requires a sacrifice of a culture's local perspective to the demands of world consumers. American culture is being exported, but for the most part it is not Amish quilts and Herman Melville. *Jurassic Park*, a movie about dinosaurs, was a huge hit abroad. But *Forrest Gump*, which makes constant reference to American history and culture, made most of its money at home.

THE VIRTUES OF LIVING AT THE MARGINS

Hollywood's export success shapes the cinematic market. First and most prominently, it finances spectacular, blockbuster productions. While many of these productions are aesthetically mediocre, others are excellent – though few critics agree on which are which. To the extent that we use audience preferences as the relevant standard of value, Hollywood clearly succeeds.

In addition to blockbusters, the financial success of the industry supports diversity; not all Hollywood products fit the least-common-denominator-model. Hollywood puts out a wide range of independent releases, creative comedies and other films that do not fit easily identifiable categories. The late 1990s, in particular, were renowned for the wide variety of high quality, non-mainstream fare coming out of Hollywood.

"Microbudget" films are far more common in the United States than in Europe. A microbudget film is one made by a previously amateur director on a minuscule budget – typically less than $100,000. Among the best known are Spike Lee's *She's Gotta Have It*, *The Blair Witch Project*, and the Coen brothers' *Blood Simple*. All of these innovative projects have been made under director control and

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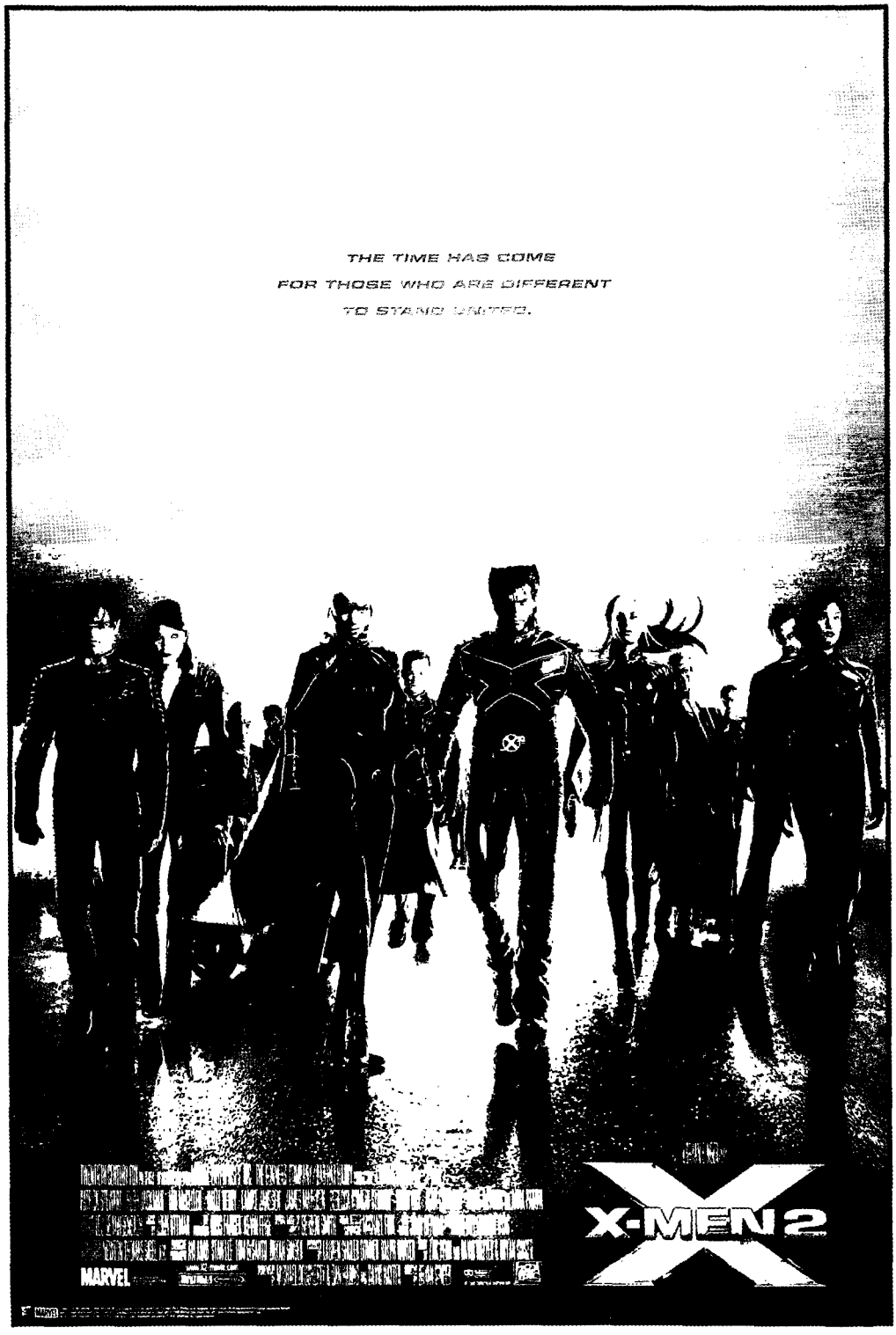

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liberated from the constraints of studio production.

It is no accident that Hollywood has both the largest studio apparatus and produces the greatest number of microbudget films. Building a film industry of any kind requires a regular supply of popular product. A healthy commercial base is needed to support an infrastructure of theaters, production companies, film schools and marketing institutions. Independent or innovative filmmakers benefit from this infrastructure, just as the major studios do.

The major studios typically seek to buy out and thereby "corrupt" the independent filmmakers, and in this sense the two cinematic worlds are always at war. But in a larger sense they are complements. The mainstream desire to commercialize the independents helps finance their existence. Directors invest in microbudget films in part because they have a chance of subsequently getting contracts from major studios. Such contracts bring both personal wealth and the resources to film their larger visions.

In addition to the Coen brothers and Spike Lee, Francis Ford Coppola, Peter Bogdanovich, Martin Scorsese, Jonathan Demme, David Lynch, Sam Raimi, John Sayles and Jim Jarmusch all first made their names with microbudget films. The directors of *The Blair Witch Project* were courted for a Hollywood sequel, which earned them millions despite its low quality. Hollywood studios, whatever their conservatism and flaws, are always looking for the "next hot thing." If they can find a microbudget production that is marketable, they will seek to co-opt it. But in the meantime, they are providing the "prizes" that drive the independent market.

European studios, by contrast, never expect high returns from projects, and thus rarely take big chances in reaching for glory. Notable European directors such as Godard, Bertolucci, Truffaut, Besson and Pasolini made their starts with microbudget films, but the overall commercial weakness of European cinema is making those kinds of opportunities harder to find and exploit.

The dirty little secret of today's cinematic world is as follows: the very features of the film industry behind American export dominance have also supported diversity of style around the globe.

It is not altogether bad that European cinema lacks the export promise of Hollywood. While commercial improvement would undoubtedly benefit European cinema, diversity would not be served by a level playing field in the industry. The dirty little secret of today's cinematic world is as follows: the very features of the film industry that drive American export dominance have also supported diversity of style around the globe.

The global prowess of Hollywood allows European moviemakers to pursue different markets and produce different kinds of creativity. Many of the interesting qualities of European movies come precisely from their *inability* to reach world markets on a large scale.

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Shut out of world markets, European movies have been able to focus on nuances of language and culture. They typically do not have happy but superficial endings, opting instead for something more interesting. The non-Hollywood productions that have success abroad, such as *Four Weddings and a Funeral* or *Like Water for Chocolate*, often have many of the flaws that plague mainstream Hollywood releases: saccharine, clichéd characters or unrealistically happy endings.

European pictures from the silent era, which had a greater chance of export success, were more like the American movies of their time than are current European productions, or European films of the 1950s or 1960s. Because they were aimed at different audience segments, European talkies did not follow the same artistic path as Hollywood. While Hollywood's asymmetric economic strength exposes it to heavy criticism, it actually supports aesthetic diversity.

Similarly, the creativity of Hong Kong moviemaking in the 1980s would not have been possible had those pictures been geared for export to America and Europe, rather than for the smaller, more specialized Southeast Asian market. The Hong Kong movie *Dr. Lamb* was a success in the Hong Kong market of the 1990s. The movie was explicitly patterned after *Silence of the Lambs*, a U.S. and global hit in 1992, but the two movies could not be more different in tone.

Silence of the Lambs plays up its two stars, Jodie Foster and Anthony Hopkins, giving them a strong, caricatured presence in the movie. They engage in witty repartee and are made into glamorous figures. The last segment of the movie plays the viewer for mechanical suspense, as Jodie Foster chases down another serial killer.

Dr. Lamb is far scarier. It never plays the viewer for suspense but instead reveals its denouement at the beginning. The killer is a sullen and nasty figure, rather than the charismatic and articulate Anthony Hopkins playing Hannibal Lecter. We see the killer dismembering his victims, indulging his perverse fetishes and having brutal arguments with his family. No feeling of resolution is offered at the end; rather, the viewer is left feeling uneasy. Not surprisingly, *Dr. Lamb* has never been released in the U.S. market.

THE FUTURE OF GLOBAL CINEMA

It remains an open question whether Hollywood will gain or lose relative market position over the next few years. European cinema does show some encouraging signs. In the year 2000, for example, French films captured 60 percent of their domestic market – the most in 20 years – largely because a few comedies were big hits. More generally, most of the major Western European countries are relying less on subsidies to support their culture. None have cut their movie industries loose, but the long-run trend appears to lie in this direction.

European governments are understandably reluctant to remove film subsidies. Once the dynamic of Hollywood export superiority is in place, most European productions, as we know them, could not survive without government assistance. Thus in the short run, laissez-faire would likely lead to a greater Hollywood presence in Europe. But in the long run, European moviemakers would be induced to make a more commercially appealing product, and not necessarily at the expense of artistic quality. The natural European advantage is in making niche-market art-house films, not blockbusters or special-effects spectaculars.

Hollywood's market position is vulnerable, given how much it spends on celebrity salaries and marketing. While these expenses

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offer Hollywood movies a huge global boost, they also mean that American moviemakers have lost their ability to control costs – often an early warning of commercial weakness. Witness the decline of the once-dominant American auto industry. Note, too, that digital technology promises to open moviemaking to outsiders by lowering the costs of production.

The history of cinema shows many times over that a truly great movie can be made for very little money. Films of this kind may not outdraw *Titanic* at the box office, but they could resuscitate cinema in the countries where it is currently floundering.

Of course it remains an open question whether European moviemakers will fill this market niche, or whether Asia is already beating them to it.

Nonetheless it is possible for Europeans to reverse unfavorable trends, as they have in the past. Hollywood had dominated the Italian market after World War II. But Italian moviemakers fought back, in part using the techniques learned from studying Hollywood releases.

European governments would like to return to something like the 1930–1970 years, which show that the strong presence of Hollywood in world markets does not mean an end to European moviemaking. After World War II, European movies were typically subsidized, but at a much smaller magnitude than today.

Martin Dale estimates that in 1960, subsidies accounted for only 20 percent of revenues of the average European film, compared to his current estimate of 70 percent. The notable movies of Truffaut, Fellini, Visconti, Bergman and others were fundamentally money-making endeavors, aimed at the competitive marketplace, despite the involvement of government at various levels.

Going back earlier, the 1930s in particular was a "golden age" for French cinema: the best-known French films of this era include *L'Atalante* (Jean Vigo), *Le Jour se lève* (Marcel Carné), *La Chienne*, *The Grand Illusion* and *The Rules of the Game* (all by Jean Renoir). Over 1,300 French feature films were released, covering a wide range of genres. Yet during this period, French cinema received no government subsidies. The legal restrictions on American films were insignificant and did not keep Hollywood productions out of the French market.

In the early silent era, France dominated world cinema markets. Before World War I, French movies accounted for up to 70 percent of the American market and even more of the Latin American market. In a reversal of contemporary trends, American filmmakers charged the French with cultural imperialism and asked Washington for trade protection. It was commonly argued that European movies encouraged lax morals and corrupted American culture.

The French responded by noting the openness of their cinematic markets and asking America to compete on equal terms. Like Hollywood today, French market dominance was then achieved without significant government subsidies.

Global cinema is, in any case, flourishing today – most of all in Asia. As for European cinema, its best hope is to rediscover an economic and cultural dynamic that combines both commercialism and creativity. Such a dynamic will require reliance on international markets and global capital, and is unlikely to flourish in a narrowly protectionist setting. The marketplace never guarantees a favorable result. But excessive insulation from competitive pressures can virtually guarantee an unfavorable result, both in economic and aesthetic terms. M

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BY ROSS DEVOL

The United States

is widely regarded as an international leader in pharmaceuticals, biotechnology and medical devices, as well as a top provider of specialized health care services. For proof, look no further than choices of the rich and the famous – everyone from Saudi princes to European jetsetters – who regularly seek out American physicians and hospitals in search of the latest and best in medical care.

The seriously ill may flock to Boston or Houston. Others may head to Los Angeles for a nip and a tuck – what San Jose is to silicon, LA is to silicone.* Yet, while a host of cities have great reputations for medicine, there has been surprisingly little effort to quantify the impact of health care on local economies.

For the past few decades, the health care sector – we include everything from hospitals to pharmaceuticals to medical insurance – has been among the fastest growing in the industrialized world. No surprise there; health care consuming seniors will account for 30 percent of the US population in a decade, while Japan and Western Europe are aging even more rapidly. The over-65 population worldwide is expected to grow from 600 million in 2000 to over one billion by 2020.

Health care consumption has doubled as a percentage of US GDP since 1970, and the growth continues apace. Indeed, biotech and biomedicine may lead the economy in coming decades, the way information technology led the latter half of the 20th century. And there is an important race under way to determine which locations will dominate.

** OK, OK. Only mass tort lawyers see opportunities in silicone anymore, but I couldn't resist the word play.*

ROSS DEVOL is director of the Milken Institute's regional economics group.

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TOP HEALTH CARE INDUSTRY REGIONS

RANKED BY EMPLOYMENT CONCENTRATION, 2001

RANK	REGION	LOCATION QUOTIENT	% OF REGION'S TOTAL EMPLOYMENT	EMPLOYMENT (thousands)
1	New England	1.25	11.4	800.97
2	Middle Atlantic	1.23	11.2	2,054.19
3	West North Central	1.05	9.6	946.93
4	East North Central	1.03	9.3	2,053.90
5	West South Central	0.92	8.4	1,191.11
6	East South Central	0.92	8.4	636.70
7	South Atlantic	0.92	8.3	2,065.76
8	Pacific	0.87	7.9	1,592.88
9	Mountain	0.85	7.7	664.80

REGIONAL CONCENTRATION

New England and the Middle Atlantic states currently stand out in terms of sector-specific concentration. Health care directly contributed 7.5 percent of New England's gross regional product in 2001, roughly one-tenth more than the average. This is impressive when you consider that health care is largely consumed locally; "exports" of specialized medical expertise are purchased only by the most affluent. These figures, of course, understate the ultimate contribution of health care to the New England economy, since the secondary effects of health care outlays ripple through the regional economy.

New England is even more closely linked to the health care sector when concentration is measured in employment. In 2001, more than 800,000 New Englanders held jobs in the sector.

The mid-Atlantic states are a close second to New England with an employment concentration index of 1.23 (that is, 23 percent above the national average) and total health care sector jobs number close to 2.1 million.

STATE CONCENTRATION

Among states, Pennsylvania has the highest concentration of health care employment, at 31 percent above the national average. Pennsylvania's strengths are in drugs, medical devices and the hospital sector.

Rhode Island ties Massachusetts for second place, with 29 percent greater than average health care employment concentration. All six New England states are above the average – and, strikingly, five are in the top 10. New Jersey is fourth, owing its lofty position to the technology side of health care: pharmaceuticals, biotechnology and medical devices. Indeed, New Jersey has the highest concentration of pharmaceutical employment in the nation, with nearly five times the average.

North Dakota is sixth in concentration mainly due to its top ranking in hospitals and nursing facilities. West Virginia ranks eighth, principally due to its second-place rank in hospitals.

Vermont (ninth overall) is first in health and allied services, and sixth in home health care services. New York is first in total health

STATE HEALTH CARE CONCENTRATION

Pennsylvania	1.31	Ohio	1.10	District of Columbia	0.98	North Carolina	0.87
Rhode Island	1.29	Maryland	1.07	Iowa	0.97	California	0.86
Massachusetts	1.29	Delaware	1.07	Michigan	0.97	Arizona	0.86
New Jersey	1.29	Montana	1.06	Arkansas	0.97	Oregon	0.86
Connecticut	1.26	New Hampshire	1.05	Indiana	0.96	Virginia	0.84
North Dakota	1.26	Indiana	1.03	Tennessee	0.95	Colorado	0.83
Maine	1.20	Florida	1.02	Washington	0.95	Hawaii	0.82
West Virginia	1.19	Wisconsin	1.01	Louisiana	0.95	Mississippi	0.79
Vermont	1.16	Missouri	1.01	Oklahoma	0.95	Georgia	0.77
New York	1.14	Illinois	1.01	Kansas	0.94	Alaska	0.71
Minnesota	1.14	United States (all)	1.00	Texas	0.91	South Carolina	0.70
South Dakota	1.12	Kentucky	0.99	Utah	0.90	Nevada	0.63
Nebraska	1.10	New Mexico	0.99	Alabama	0.88	Wyoming	0.55

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care employment (with 900,000 workers) and 10th in overall concentration.

METROPOLITAN AREA HEALTH POLES

The Milken Institute created the Health Pole Index for metro areas (MSAs) as a way of offering a more comprehensive measure of the impact of the health care industry. Rankings are based on a combination of relative and absolute rankings – an MSA's concentration of health care employment relative to the nation as a whole, and its share of national health care industry output. The metro area with the highest composite score is assigned a benchmark score of 100. The principles behind this method were introduced with the Milken Institute's mapping of metropolitan "tech poles" in 1999 – the first of its kind. The tech-pole concept is detailed in *America's High-Tech Economy: Growth, Development and Risks for Metropolitan Areas* (available for $15 in paper, or download free from www.milkeninstitute.com).

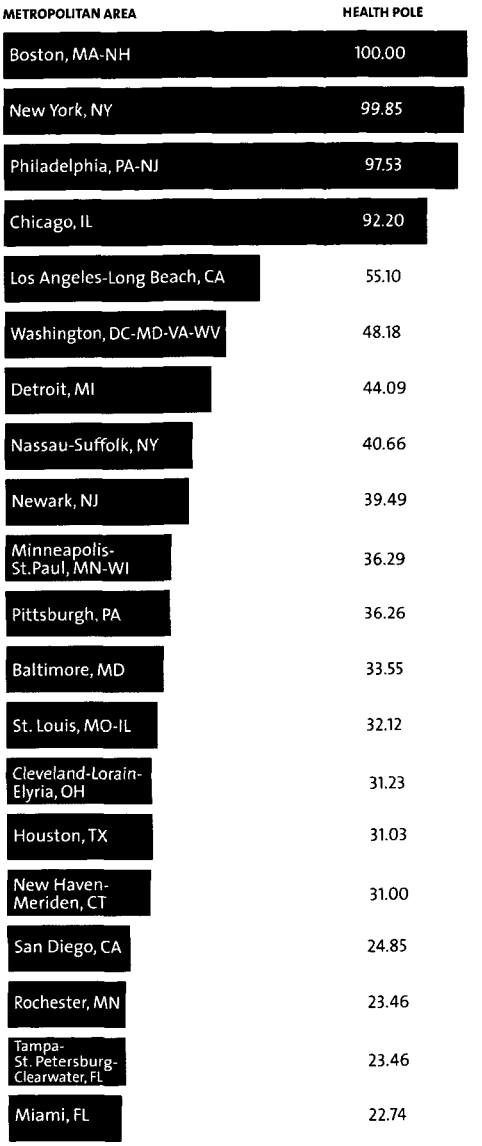
Tech-pole scores capture the spatial intensity of a variety of technology-driven sectors. The health-pole index (and the individual industry health-pole scores, available on our Web site) captures the spatial intensity of the health care industry.

In light of New England's commanding presence in health care, it should be no surprise that the region's largest MSA, Boston, is the top health pole. It is a center for both biotechnology and medical device research and commercialization. Genzyme and Biogen serve as its biotech anchors. The MSA boasts three top-rated medical schools (Boston University, Tufts and Harvard), while Massachusetts General Hospital is the sixth-largest employer in Boston.

The New York metro is a very close second. New York is first in hospital employment and in the top 10 in several other categories. The Big Apple has some of the top teaching hospitals in the country and is a leader in clinical trials. The New York Presbyterian Healthcare Network is the top employer in the metro area.

TOP 20 METROPOLITAN AREAS BY HEALTH POLE

TOTAL HEALTH CARE EMPLOYMENT, 2001



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INSTITUTE VIEW

The Philadelphia MSA places a strong third on the index with lofty rankings in drugs, medical services and health insurance, and hospitals. Merck employs 11,000 and Wyeth has 6,300 on staff in the metro area. A remarkable seven out of the top 10 employers in the Philadelphia area are in health care related firms.

Chicago is fourth overall (by being first in medical services and health insurance and third in hospitals). Hospitals alone employ more than 150,000 people in Chicago, making it the top employment sector in the MSA.

Los Angeles is a distant fifth with strength in physicians' offices, dentists and medical laboratories. Cedars-Sinai Medical Center has a staff of 8,600. Much of the research leading to the first commercially successful biotechnology therapy was conducted at the City of Hope's facilities. The metro area is, of course, home to some of the world's preeminent plastic surgeons. Kaiser Permanente, the giant HMO, is the largest employer in the Los Angeles MSA.

The Washington, DC metro area ranks sixth overall. It is home to the National Institutes of Health (15,400 employees) and many other key health care research and advocacy groups. The human genome code was mapped in the Washington MSA. The city's biotech sector is large and expanding rapidly, ranking Washington first in the nation in research and testing services.

Detroit has also become a major player in health care services, ranking seventh in our Health Pole Index. The MSA owes its prominent position to hospitals and osteopathic physicians. The Nassau-Suffolk MSA on Long Island is eighth. The MSA's top employer is a health care services firm, the North Shore-Long Island Jewish Health System.

Newark owes its rank (ninth overall) to its top ranking as a pharmaceutical center. Merck, Schering-Plough and Pfizer are among the top employers. Minneapolis-St. Paul rounds out the top 10. Allina Health Systems is the third-largest employer in the region.

Pittsburgh ranks 11th. The University of Pittsburgh Health System employs 31,000 workers, making it the MSA's biggest employer. West Penn Allegheny is Pittsburgh's second-largest employer. Anchored by Johns Hopkins, Baltimore is an important center for hospitals – which explains its 12th ranking. St. Louis' placement at 13 is attributable to hospitals and nursing and personal care facilities. Cleveland (14th) is home to the world-renowned Cleveland Clinic, which is the MSA's largest employer (23,400).

Houston (15th) has one of the world's leading cancer-research institutes, the University of Texas' M.D. Anderson Cancer Center. New Haven-Meriden, Conn. is 16th with a major teaching hospital (Yale), and strength in medical instruments and drugs. No fewer than 11 of this MSA's top-20 employers are in the health care industry.

San Diego's ranking at 17 is largely due to its strength in biotech, in which it is second only to Washington, DC. San Diego is home to Scripps Research Institute as well as biotech firms including Nanogen and Ligand. Rochester, Minnesota (18th) is on the map thanks to the Mayo Clinic, which accounts for an astounding 27 percent of the MSA's total employment. Tampa's retiree population explains its position at 19th. Ditto for Miami, which ranks 20th and is home to Jackson Memorial Hospital.

Note that only three MSAs in the West (Los Angeles, Houston and San Diego) make the top 20, while the Northeast corridor has six of the top 10. Just what that bodes for the long-term health of the regions (pun intended) is anyone's guess. M

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CRIME DOESN'T PAY

Nobel Prizes are a very big deal in economics. But the rarer – and, arguably, more prestigious – honor within the profession is the John Bates Clark Medal, awarded every other year by the American Economic Association to an American practitioner under the age of 40.

The 2003 award went to Steven Levitt (age 35!) of the University of Chicago, who has the knack for ferreting the profound from the obscure. Among the subjects of his recently published papers: sumo wrestling, drunk driving, teachers who cheat, soccer penalty kicks and Congressional pork barrel spending.

One striking paper: an analysis of the economics of illegal drug retailing, based on the detailed records of a street gang. Levitt concludes that average drugsellers' wages are wretched (many net less than the minimum wage). But, like other contemporary industries, incomes are highly skewed with overwhelming winner-take-all characteristics.

"An Economic Analysis of a Drug-Selling Gang's Finances" (with Sudhir Venkatesh) appeared in the *Quarterly Journal of Economics* (August 2000). Download a version from the National Bureau of Economic Research at www.nber.org/papers/w6592.pdf ($5 charge).

CRYING FOR ARGENTINA

What makes Argentina – a country that by rights ought to be among the richest in the world – the longest running failure in the history of economic development? Guillermo Perry and Luis Serven of The World Bank don't claim to know what Madonna and Andrew Lloyd Webber couldn't figure out in the movie version. But they do know a lot about why Argentina's last experiment with bootstrap development, built around the "dollarization" of the economy, ended so badly. Read it and, if you absolutely must, weep.

Download "The Anatomy of a Multiple Crisis: Why Was Argentina Special and What Can We Learn From It?" at econ.worldbank.org/view.php?type=5&id=27742

GOOD NEWS FROM DISMAL SCIENTIST

As Gary Becker notes in this issue (page 68), not all the news about income distribution is depressing. He cites research by Xavier Sala-i-Martin, a Catalan who teaches economics at Columbia University. Thanks largely to growth in China, the number of people living on less than $2 a day has been cut by more than half in the last three decades – and the total number of desperately poor people is down by as much as a half billion.

Yes, income equality has increased *within* virtually all countries. But thanks to good happenings in Asia, this is more than offset by the narrowing of differences between rich and poor countries.

"The Disturbing 'Rise' of Global Income Inequality" is NBER Working Paper 8904. Download at www.nber.org/papers/w8904.pdf ($5 charge).

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MEMO TO BUSINESS SCHOOL DEANS:

Did you get a bad rating in one of those surveys of MBA programs? Relax – the next survey is likely to show very different results. Consider the bizarre variations below. Dartmouth's Tuck School took top honors from *The Wall Street Journal*, but came in 16th in the *BusinessWeek* survey. The Stanford program, which *U.S. News & World Report* and the *Financial Times* thought was top-drawer, placed a wretched 39th in the *WSJ* survey – behind SMU, Wake Forest and Thunderbird.

Why the differences? Measurement criteria varied. *Forbes* ranked schools according to returns on investment in tuition and foregone wages. The *WSJ* based its rankings on the opinions of corporate job recruiters, while *U.S. News* used a complicated index that included everything from deans' ratings to starting salaries. Still, it's hard to avoid the conclusion that there is less here than meets the eye. Oh, there's one other thing: rankings do sell newspapers and periodicals (maybe even this one). Stay tuned for the top 10 restaurants in Baghdad and 50 new ways to leave your lover.

SCHOOL	U.S. NEWS 2003	FINANCIAL TIMES 2003	WALL STREET JOURNAL 2002	FORBES 2001	BUSINESSWEEK 2000
Harvard	1	2	9	1	3
Stanford	2	4	39	10	11
Penn	2	1	5	2	1
MIT	4	10	30	8	4
Northwestern	4	9	4	9	2
Columbia	6	3	10	3	7
Duke	7	15	25	11	5
Univ. of California (Berkeley)	7	15	16	15	18
Chicago	9	5	6	5	10
Dartmouth	10	11	1	4	16
Virginia	11	14	20	13	9
New York University	12	8	24	22	13
Michigan	13	25	2	19	6
UCLA	14	20	36	12	12
Yale	14	12	8	6	19
Cornell	16	19	19	7	8
Carnegie Mellon	17	23	3	14	14
Texas	17	32	7	NR	17
Ohio State	19	39	18	NR	NR
USC	20	31	35	NR	24
Emory	21	29	17	18	NR
North Carolina	21	23	12	16	15
Indiana	23	45	14	23	20
Georgetown	24	17	*	24	29
Purdue	24	47	11	NR	25

*not in top 50.

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